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TAX REFORM PROPOSALS—XIV

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 16, 1985

Housing, Real Estate, and Rehabilitation

ORIGINAL

Printed for the use of the Committee on Finance

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TAX REFORM PROPOSAL—XIV

TUESDAY, JULY 16, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Heinz, Wallop, Symms, Grassley, Long, Bentsen, Matsunaga, Moynihan, Bradley, and Mitchell.

[The press release announcing the hearing follows:]

[Press Release, June 25, 1985]

TAX REFORM HEARINGS IN FINANCE COMMITTEE TO CONTINUE IN JULY

Examination of President Ronald Reagan's tax reform proposal will continue in July with a series of hearings before the Senate Committee on Finance, Chairman Bob Packwood (R-Oregon), said today.

"We made a good start on the hearing portion of this long process toward overhaul of the Internal Revenue Code during June," Senator Packwood said. "The hearings we have scheduled for July will take us further toward our goal of having a bill to the President by Christmas."

The hearing announced today by Senator Packwood includes: On Tuesday, July 16, the committee will receive public testimony on the impact of the President's proposal on housing, real estate and rehabilitation.

The **CHAIRMAN**. The hearing will come to order, please. Today is a continuation of the hearings on the President's tax reform bill, and the subject today is almost solely real estate. We have attempted to divide our hearings into different appropriate subjects. Needless to say, the issue of real estate is one of the more significant and major issues in the bill because there are so many provisions of the President's suggested bill that touch upon real estate. So, we will open today with a panel, and we will go in the order that you are on the panel list unless, between you, you have worked out a different order. John Koelemij, the president of the National Association of Home Builders; J. McDonald Williams, chairman of the board of the National Realty Committee; William Moore of the National Association of Realtors; Sheldon Cohen, senior partner at Morgan, Lewis & Bockius in Washington; and Prof. Paul R. McDaniel, professor of law at Boston College. And as you are all aware, your statements in their entirety will be in the record, and we would ask you to limit yourselves to 5 minutes so that we can ask you as many questions as we choose to ask you. I believed we are read to start, and we will start with Mr. Koelemij.

STATEMENT OF JOHN KOELEMIJ, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. KOELEMIJ. Thank you, Mr. Chairman and members of the committee. My name is John Koelemij, and it is an honor to appear before you today as president of the National Association of Home Builders, NAHB for short, representing more than 133,000 members. We appreciate the opportunity to present our views on this far-reaching tax reform proposal. The President's tax proposals are of great concern to the membership of NAHB, and will increasingly become a concern of homeowners and renters alike when the impacts of the proposal become known.

We agree that tax reform is needed to create fairness and to assure that all taxpayers, both corporations and individuals, pay their fair share of tax. However, we strongly believe that the following principles should guide any major rewrite of the Nation's tax laws. First, tax reform should enhance economic growth, savings, and investment, not retard them. Second, tax reform should be revenue neutral, certainly not creating a revenue loss which only adds to the Federal deficit. Third, tax reform should be fair and not disproportionately affect one industry or a group of individuals at the expense of another. And fourth, tax reform should not erode the national commitment to home ownership and affordable rental housing.

As this committee proceeds with the task of rewriting the Tax Code, we urge you to consider the fact that there has been a major reduction in direct Federal housing spending over the past several years, particularly for low- and moderate-income people and the elderly. This has left the Tax Code as the cornerstone of national housing policy. The decisions you make on this proposal, to a great extent, will affect the production of housing, the rents paid for housing, and even the value of housing. On the question of timing, we urge the committee and the Congress to complete serious action on the national deficit problem before consideration of tax reform.

NAHB is pleased that the proposals retain the mortgage interest deduction for principal residences, the capital gains deduction for sales of principal residences, and the partial exclusion of gains for home sellers who are at age 55 and older. There are four provisions in the President's proposals, however, that would adversely affect single-family housing. There are nine provisions that adversely affect multifamily housing. These provisions are listed in attachment A of my summary statement. NAHB has conducted an economic analysis of the potential effects of the President's tax reform proposals upon housing costs. Mr. Chairman, I ask that, in addition to my written statement, this analysis be made part of the hearing record.

The CHAIRMAN. That will be done.

Mr. KOELEMIJ. Thank you. Our analysis shows that after-tax homeownership costs will increase by 8 to 14 percent if all portions of the President's tax proposals are enacted. However, our primary concern on the impact of the reform proposal as it relates to homeownership is the question of affordability for first-time home buyers. Two aspects of the President's proposal—the repeal of revenue bond financing and the curtailment of installment sales reporting with regard to homeowner bonds, sometimes called builder bonds—would fall most heavily upon the low and moderate income, first-time buyers, the group most adversely affected by high interest rates.

We also are very concerned with the provision that would limit mortgage interest deductions other than for the primary residence. In addition to setting a bad precedent, we believe that enactment of such a provision would have a substantial adverse impact on the economies of many communities throughout the United States.

In the case of multifamily housing, the immediate impact of the enactment of the President's proposals would be a substantial downturn in construction and a devaluation of existing rental properties, perhaps as much as 20 percent. This drop in construction reflects the fact that most new projects would no longer be economically feasible. NAHB estimates that for a typical, new conventionally financed project to be economically feasible, rents would have to be from 21 to 28 percent higher under the President's proposals. The loss of IDB financing for moderate income projects would require even larger rent increases.

Such rent increases will not occur overnight, but new construction will drop instead. Then market forces will set in, and vacancy rates will fall, and rents for existing apartments will start a steady rise with increases of about 15 percent over and above inflation in the next 5 years. This will begin to revive new rental construction, although still at reduced levels.

In closing, Mr. Chairman, I would like to note that although some have referred to those who have not fully embraced the President's tax program as special interests, we believe that housing more than a special interest. It is a national interest and an important national priority. Thank you very much.

The CHAIRMAN. Mr. Koelemij, thank you. Don Williams? It is good to have you with us.

[The prepared written statement of Mr. Koelemij follows:]

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
COMMITTEE ON FINANCE
UNITED STATES SENATE
on
IMPACT OF THE PRESIDENT'S TAX REFORM PROPOSALS ON HOUSING

July 16, 1985

Mr. Chairman and Members of the Committee:

My name is John Koelemij and it is an honor to appear before you today as President of the National Association of Home Builders (NAHB), representing more than 133,000 members. I am also a builder of single family and multifamily homes and an owner of rental property in Tallahassee, Florida.

Mr. Chairman, I want to commend you for the lengthy hearings you are holding on the President's tax reform proposals and I appreciate the opportunity to testify. These hearings are necessary because if comprehensive tax reform is to be enacted, Congress first should explore all of the ramifications that such legislation could have upon the economy.

We agree that tax reform is needed to create fairness and to assure that all taxpayers, both corporate and individuals, pay their fair share of tax. Based on surveys conducted for NAHB we have found that there is broad support for the concept of tax reform among the American public. However, in the same survey, we found that there was a great deal of uncertainty and concern as to the precise nature of tax reform. There are some basic questions that must be addressed:

o What will be the impact on economic growth and on savings and investment?

o How can we best design a fair tax system? (One that will not hurt the middle-income taxpayer who has already borne the greatest tax burden in our society for many years.)

o What will be the budgetary impact of tax reform?

o What will be the impact on the homeowner and renter?

I. Overview

The Federal Government long has been committed to encouraging housing and has used tax policy as a significant and conscious instrument of Federal policy to attain housing goals. The deductibility of mortgage interest has helped to make the U.S. a nation of homeowners and affordable rental housing has been made possible by tax incentives provided for individuals to invest in rental housing. This tax policy has made possible increased rates of homeownership, a comfortable standard of housing for most households, and a steady decline in the amount of substandard housing.

Affordable rental housing is an essential part of our social policy today. Rental housing must be available for those who are unable financially or who do not desire to own their own home. As I will explain, later, rental housing would not be an attractive investment without tax incentives. Absent tax incentives, the availability of rental housing would decline and the cost to renters would increase.

Because of the effect of tax policy upon housing and housing policy, tax revisions should not be viewed in isolation from other changes in housing policy and programs. Housing and urban development programs already have been cut by over 50% since 1980. Now they are being singled out further for deep reductions or elimination. According to NAHB estimates, housing's share of the proposed budget reductions represents about $4 billion or 25% of the cut in discretionary spending. Given the enormous reductions in housing related programs since 1980, this is simply not fair or responsive to the growing needs of lower income families and the elderly. If these budget reductions are enacted, the HUD budget will drop from 5.3% of the total Federal budget in FY'80 to 0.7% in FY'86. Given this reduction in direct spending for housing programs, it is clear that housing policy now has shifted to the tax writing committees.

Tax policy is of major importance to those who construct housing, to those who finance housing, and, thus, to those who reside in housing. We need a consistent tax policy that reaffirms our national commitment to affordable, quality housing -- both for homeownership and for rental housing. A consistent policy of support for decent housing and homeownership has been a national commitment for more than fifty years. This principle should continue to be a priority in any tax policy.

Enactment of the President's proposals would have a profound effect upon individuals and businesses, particularly the housing sector, as well as on homebuyers, homeowners, and renters. In fact, the President's proposals represent a fundamental change in the philosophy and objectives of taxation affecting many areas of the economy, and those effects must be weighed before proceeding with comprehensive tax revision.

II. Tax Incentives and Housing Policy

Homeowners

Several important tax incentives have been established for owner-occupied housing. These include the mortgage interest deduction, the deduction for real estate taxes, the deferral of capital gains on the sale of a home, and the one-time exclusion for capital gains of up to $125,000 on the sale of a personal residence for individuals who are 55 or over.

Of all tax deductions allowed by present law, the mortgage interest deduction, probably has the highest level of appeal to middle-class Americans. These deductions make homeownership affordable for many Americans. For example, take a married couple with two children and filing a joint return. Under current tax law, and assuming a family income of $35,000 per year, the mortgage interest deduction helps this family afford a $74,000 home. Without the mortgage interest deduction, the same family could afford only a $59,000 home. With the median price of a new home in the $80,000 range, the importance of the mortgage interest deduction in permitting ownership of a home is evident.

While the President's proposal does not tamper with the mortgage interest deduction for principal residences, it would deny the deduction for property taxes and would limit the amount of interest that could be deducted with respect to mortgages on second homes. As I will explain, later, elimination of the deduction for property taxes would cause housing costs to increase. Moreover, elimination of this deduction would mean that homeowners will be taxed twice on the same income, once by the State or local government and again by the Federal Government.

For interest other than on mortgages or principal residences, the President has proposed an annual limitation of $5,000 plus net investment income. All interest other than that with respect to owner-occupied homes or businesses would be under this cap. Thus, the cap would apply to interest on vacation homes and automobile purchases, interest paid or incurred by limited partners, and interest paid on other consumer loans (e.g., college education). We are concerned with the impact that this cap could have on vacation communities. In addition, we are concerned that should Congress enact a cap on interest deductions other than those with respect to mortgages on principal residences, it might not be too long before the Administration or Congress sought to place a cap on principal residences as well.

We also wonder about the fairness of the proposed interest limitation in that it would seem to discriminate in favor of the wealthy. That is, an upper-income taxpayer could shelter his investment income with interest deductions. However, a middle-or lower-income taxpayer, who is likely to have the greatest need to borrow, most likely will not have much investment income and will be confronted with the cap when he or she considers borrowing to send a child to college or to buy a new car. While a $5,000 interest cap may sound sufficient to cover most purchases, we wonder how meaningful that figure will be in 1995, when the interest limitation is phased in fully. Finally, we are concerned that individuals will be encouraged to borrow against their homes in order to circumvent the limitation. For many individuals, their homes represent the bulk of their savings. We wonder whether this erosion of equity should be encouraged.

In summary, we are pleased that the President's proposal has retained the full deduction of interest payments on principal residences, rollover of capital gains, and the exclusion for gains of home sellers age 55 or older . However, as I will explain more fully in my testimony, in the absence of interest rate declines, the net effect of the proposal will be to increase the cost of homeownership and reduce the value of existing homes.

First-time Homebuyers

Two major home mortgage innovations that have helped to address the problem of affordability of homes are tax-exempt mortgage revenue bonds and homeowner bonds (sometimes called "builder bonds").

Approximately one million low-and moderate-income Americans have bought homes with help from the single-family mortgage revenue bond program since the early 1970's. Mortgage revenue bonds make housing more affordable by allowing State and local housing finance agencies to convert tax-exempt funds borrowed at low interest rates into mortgages that are typically 2 percentage points or more below the conventional mortgage rate.

Since 1980, loans funded by mortgage revenue bonds have been restricted by Federal law generally to first-time buyers of modestly-priced homes. In addition, these loans may be targeted to economically-distressed areas, and most State and local issuers impose income limits. A 1982 General Accounting Office study found that 72 percent of mortgage revenue bond mortgages went to households with incomes below $30,000 and that the average mortgage amount was $48,000.

We are dismayed that the President has proposed repeal of mortgage revenue bonds because they have been an effective means of providing affordable financing to households who otherwise would be unable to achieve homeownership due to continuing high interest rates. In fact, homeownership among young families has been on the decline for the last five years. Since 1980, there has been a 5 percent decline in homeownership for families with heads of household aged 30-35.

As I mentioned earlier, another home mortgage innovation that has helped to address the affordability problem is homeowner bonds. The interest on homeowner bonds is fully taxed; however, unlike a traditionally-financed home sale in which the builder receives cash at closing, under a homeowner bond program, the builder receives a downpayment and takes back a mortgage. The builder then receives regular principal and interest payments until the mortgage is retired. Because the builder receives only a portion of the purchase price each year, the builder's early year tax liability is substantially lower than for the traditionally-financed builder; however, the builder will pay greater taxes in later years. This installment sale tax treatment commonly is used by large corporations in other industries with financing subsidiaries. The adaptation of the installment sale tax treatment to the industry has substantial benefits both for homebuilders and homebuyers.

Homeowner bonds allow the builder to tap directly into the national capital markets to provide homebuyer financing. The builder uses a pool of mortgages or mortgage-backed securities to collateralize the bond issue. The development of homeowner bonds has led institutional investors to show an unprecedented willingness to channel their capital into housing. In addition, because of the builder's direct access to major credit markets and because of the installment sale treatment on homes financed through the bonds, builders can provide affordably priced and financed housing through the use of homeowner bond financing. This is particularly important in an age when thrift institutions are diversifying into areas other than housing.

While homeowner bonds are not restricted specifically to moderate income, first-time homebuyers, they have been used primarily by large volume builders offering FHA and VA loans. Thus, they primarily have benefited such buyers.

The President's proposal to deny installment sales treatment to builders who pledge mortgages as collateral for bonds would curtail the development of builder financing and raise mortgage rates and home prices. Furthermore, we feel that the denial of installment sale treatment where the obligation is used as collateral is inequitable, because highly liquid companies, whose superior access to credit markets precludes the need to pledge receivables as collateral, would still enjoy the installment sale tax advantage. Finally, we are concerned that the Treasury Department has not provided any sound data regarding revenue loss that would justify this proposed tax change. In fact, there is no tax loss, although there is tax deferral. During 1984, the housing industry issued a total of $3.7 billion in homeowner bonds. Our preliminary data for 1984, indicates a tax deferral for that year of under $100 million.

Rental Housing

Tax incentives attracting investment capital have been the lifeblood of the rental housing market, which serves one third of all American households, including the poor who cannot afford to own their own homes. Without tax incentives to encourage the private sector to build rental housing, the Federal Government's obligation to assist low-income Americans in obtaining housing would have to be far greater than it is today.

The taxation of investment in rental housing is complex. Different provisions in the Internal Revenue Code affect a variety of participants in the development process: developers, builders, and investors. The major tax provisions that have affected rental housing are:

- The accelerated cost recovery system (ACRS depreciation).
- Rehabilitation tax credits.
- Capital gains exclusion.
- Forms of ownership that allow for "flow-through" taxation as a way to attract capital.
- Exemption from the "at-risk" rules.
- 10-year amortization for construction period interest and taxes.

° Tax-exempt industrial development bonds for multifamily housing.

The President's proposal would affect investment in rental housing by:

° Reducing the depreciation allowance for rental structures to about four percent per year, calculated on an indexed basis, and lengthening the cost recovery period from 18 years to 28 years.

° Including construction period interest and taxes in depreciable basis (instead of allowing 10-year amortization).

° Repealing favorable capital gain treatment for buildings used in a trade or business.

° Treating limited partners' interest as investment interest (subject to a deduction cap of net investment income plus $5,000).

° Restricting limited partners' deductions to cash invested and amounts for which there is personal liability (extension of the at-risk rules to real estate activities).

° Eliminating industrial development bonds for multifamily housing.

° Eliminating 60-month amortization for low-income housing rehabilitation expenditures.

° Eliminating rehabilitation tax credits.

Furthermore, we are concerned that the proposal repeals all special incentives for investment in low-income housing.

We believe that changes in the current tax rules severely would disadvantage investment in rental housing compared to other types of investment alternatives. The history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes be capitalized was enacted in 1976. That provision requires that construction period interest and taxes either be added to the basis of property or be amortized over a 10-year period. Residential real estate also does not enjoy the advantage of the investment tax credit, except in the case of rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds. Finally, the Deficit Reduction Act of 1984 (DEFRA) had a significant impact upon investments in real estate. Among the many significant items in DEFRA affecting real estate investments were provisions that:

- Increased the recovery period for real property (other than low-income housing) from 15 years to 18 years;
- Imposed immediate recapture of depreciation in installment sales;
- Restricted issuance and use of industrial development bonds;
- Expanded the original issue discount rules to cover sales of property;
- Limited deductions of start-up costs for new ventures;
- Imposed higher test and imputed interest rates on transactions involving deferred payment sales of property;
- Expanded the rules relating to amortization of construction period interest and taxes; and

* Eliminated tax-free exchanges of partnership interests, and tightened up generally in the area of partnerships.

We believe that the ACRS recovery allowance for structures, adopted in 1981, should not be revised to reduce current depreciation allowances.

From an investment point of view, rental housing often has been unattractive. Intensive management is necessary both to maintain rental housing and to assure a steady stream of income. The cost of maintenance of rental property has increased considerably in recent years. Furthermore, income generated from rental property is lower than for other types of property.

Residential rents generally do not provide for CPI inflation increases, and the income of residents can support only a certain level of rent. Accordingly, market rents generally do not create an income stream that is competitive with other types of investments. Moreover, rent controls in many jurisdictions have kept rents at below market levels.

These are the reasons that residential housing must retain current depreciation allowances in order to be competitive with other types of investments. A reduction in present depreciation allowances, shortly following the DEFRA reduction, would drive capital away from residential housing at a time when more, rather than less, capital is needed.

In 1981, NAHB supported ACRS depreciation because of its certainty and simplicity. However, it is a misconception to believe that ACRS significantly increased depreciation deductions for new residential construction. In fact, under the law prior to the 1981

Tax Act, component depreciation plus the ability to use the double declining balance method of depreciation sometimes provided a more advantageous depreciation situation for new housing than was the situation after ACRS. Component depreciation often provided larger total depreciation deductions over the first six years than does ACRS.

The President's tax reform proposals would substantially alter depreciation allowances for rental property by repealing ACRS. Buildings would be depreciated over a 28-year period rather than the 18-year period that currently applies to most buildings. The depreciation allowance in the proposal would not be heavily concentrated in the initial years, because depreciation would be calculated on a 112 percent declining balance basis rather than on a 175 percent declining balance basis. Because there would be an inflation adjustment, depreciation would be greater in the later years than the early years, and could total more than the initial cost over the 28-year life. However, it is unclear what effect the application of the at-risk rules to real estate will have upon cost recovery. That is, even though depreciation deductions would increase with time, if the at-risk rules are applied to real estate activities, then an investor would have to continue putting in cash, or otherwise increasing his at-risk basis, in order to claim those deductions. Therefore, we are surprised that the President's proposals do not index at-risk basis, as well as the property's basis.

Despite the inflation adjustment, the proposed depreciation schedule generally is less attractive for rental housing than current law. Even if the property is held for 28 years, the present value of the proposed depreciation schedule is less than the value of current ACRS depreciation at real rates of discount over 6 percent, assuming 6 percent inflation. For more typical holding periods of 8 to 10 years, the advantage of current law is greater. Also, at lower rates of inflation, the advantage of current law is greater.

While I have dwelled somewhat on depreciation, there are several other aspects of the President's tax reform proposal that would have an adverse impact on rental housing. Let me now highlight some of these proposals.

Tax-exempt industrial development bonds (IDBs) have been a major source of financing for newly-constructed low- and moderate-income rental housing. During 1984, IDB financing was used for the majority of low- and moderate-income rental housing units in structures with five or more units. Tax-exempt IDBs can reduce the interest rate on multifamily mortgages by 200 basis points or more, making it possible for investors to build projects that otherwise might not have been feasible and, thus, contributing to moderation in rents. The elimination of IDB financing would remove the current primary source for financing new low-and moderate-income rental housing.

If there are improvements that would better target the multifamily IDB Program, we are prepared to work with the Committee to explore ways to reach that goal.

The proposal to eliminate the capital gains deduction for depreciable property, if enacted, would remove a major attraction of investment in real estate and would mean that investors would have a higher price to pay when they dispose of an investment interest. No doubt, this would have an impact on the decision of whether or not to invest in the first place. The impacts of the proposed changes in capital gains and depreciation are closely linked. Under present law, each dollar in tax savings from rapid depreciation generally is offset by less than a dollar in taxes upon subsequent sale of the property, because of the favorable treatment of capital gains. Under the President's proposals, however, each dollar in tax savings from depreciation would be offset by more than a dollar in additional tax upon sale.

The President's proposal not only would cut back on incentives for investment in residential rental property and eliminate tax-exempt IDB financing, but it also would place restrictions on limited partnerships. Largely because of their flexibility, their ability to accommodate large numbers of investors, limited liability, and the "flow-through" of tax attributes from the partnership to the investor, limited partnerships have become the primary vehicle for equity investment in rental properties. The President has proposed to restrict the usefulness of limited partnerships as an investment vehicle in two ways. Present law limits the deductibility of "investment interest," but interest incurred in a trade or business, even if the investor is not actively engaged in the management of the business, is fully deductible. This current deductibility of interest is an important feature of investments in real estate limited partnerships. The President's proposal would treat interest expense from limited partnerships as investment interest and, further, would limit the deduction of investment interest to $5,000 plus net investment income.

In addition, the President's proposal would extend the "at-risk" rules to real estate investments. Currently, lenders to real estate activities generally look only to the value of the property securing the loan in the case of default. That is, the limited partners generally have no personal liability with respect to the borrowed funds, except to the extent of their cash investment. This is another feature of present law that makes the limited partnership an attractive vehicle for investments in real estate.

The extension of the at-risk rules to real estate would force investors in real estate either to accept personal liability for debts of the partnership or to face reduced tax benefits. The application of the at-risk rules also would provide an incentive for more rapid, uneconomic turnover of real estate investments. While it is difficult to quantify the likely impact of these restrictions on limited partnerships, we are concerned that these proposals could restrict severely the free flow of capital into housing.

A primary concern for us with regard to the President's tax reform proposal is that it would eliminate all distinctions between rental housing and other types of structures and between low-income rental housing and rental housing in general. Under present law, rental housing is subject to more liberal recapture provisions than other structures. Low-income housing currently benefits from more rapid depreciation, favorable recapture rules, expensing of construction period interest and taxes, and 5-year amortization of qualified rehabilitation expenses. Moreover, the elimination of IDB financing for multifamily housing would have a disproportionate impact on low-and moderate-income rental housing. Thus, the adverse impact of the President's tax reform proposals would be greater for rental housing than for office buildings, stores, and other commercial structures; while the adverse impact on low-income rental housing would be even greater.

One final point that I would like to address is the so called "windfall" depreciation tax, which would apply to depreciation taken from January 1980 through June 1986. While this provision would have little direct impact upon new investment in rental housing, it could, by establishing a precedent for retroactively eliminating tax benefits, have the effect of increasing the perceived risk of such investment and, thus, raise required yields. Furthermore, we are concerned with the equity of this provision. Many real estate investors chose specifically to depreciate buildings on a straight-line basis so that they would not have to recapture depreciation at ordinary income rates. Since these investors chose to claim less rapid depreciation in order to avoid the recapture problem, we feel that it would be unfair to tax them now on "excess depreciation". Even those investors who elected rapid depreciation for buildings expected recapture to be the difference between accelerated depreciation and straight-line depreciation over a 15- or 18- year period, depending upon the year the property was placed in service, rather than the difference between accelerated depreciation and straight-line depreciation over a 35- or 40- year period.

III. Economic Impacts

NAHB conducted a thorough analysis of the potential impacts of the President's proposals on the cost of housing and housing activity.

A report summarizing the results of that analysis is being submitted as an appendix to our testimony. Let me summarize the results of our studies.

Housing costs

Despite retention of the mortgage interest deduction, the tax savings associated with homeownership would be cut significantly under the President's proposals. This implies that housing costs would be increased for most homeowners. Furthermore, many families hoping to achieve homeownership would find that step made much more difficult due to the proposed elimination of special programs targeted to first-time buyers.

If all of the President's tax reform proposals were enacted, there would be an increase in homeownership costs ranging from 8 percent to 14 percent for most taxpayers. (First-time homebuyers who otherwise would have benefited from mortgage revenue bonds or homeowner bonds will likely face a larger increase). This would be comparable to the increase created by a permanent shift upward in interest rates of 1.5 percent or a jump in housing prices of $10,000. Such an increase in homeownership costs could reduce the value of many existing homes, and lead to a short-term decline in homeownership.

Because of the proposed limitation on interest deductions, the President's proposals significantly would increase the cost of owning a second home. In some cases, such as where a family temporarily owns two homes (e.g, because they have relocated and have not yet sold their former residence), the result simply may be a significant increase in taxes. However, in the case of resort property, the impacts could include a significant decline in property values and the local economy.

Rental housing

The immediate impact of the President's tax reform proposals would be a decline in the volume of new construction activity and a reduction in the value of existing properties. However, over time, the effect would be declining housing quality and substantially higher rents. Rent increases would be the greatest for low-income units, and low-and moderate-income renters quickly would find that rent increases far outweigh any tax savings they would enjoy as a result of tax reform.

Taking into account only the proposed changes in tax rates, capital gains, depreciation, and amortization, the rents required to provide an adequate return to investors in a typical new conventionally-financed rental housing development would be about 21-28 percent above the rents required under current law, assuming no change in interest rates or other costs. For low-and moderate-income rental housing that is currently financed by tax-exempt Industrial Development Bonds, the increase in required rents would be about 38-45 percent.

Actual increases in rents of that magnitude would not occur over the short run. The impact would instead be a sharp decline of new construction of multifamily rental housing and a sharp drop in the value of existing properties. Shortages of rental housing would develop, as the normal increase in demand collided with minimal new construction, condominium conversions, and abandonments. Gradually, market rents would increase to the level necessary to attract new construction. The primary burden of this painful adjustment process would fall on lower income households, who would see their housing deteriorate and rents increase to a greater extent than higher income renters.

Construction activity

The projected increase in homeownership cost is roughly equivalent to a 1 1/2 percent increase in mortgage rates. Generally, a 1% increase in mortgage rates will reduce single family starts by about 100,000 units in a year. However, there are several important differences between the proposed tax changes and a change in interest rates. Thus, a reasonable estimate of the first year reduction in single family starts solely due to the change in after-tax homeownership cost would be 50,000 units.

Taking into account the proposals relating to mortgage revenue bonds, homeowner bonds, and interest deductions, we predict that in the first year of implementation, single family housing starts would decline by 95,000 units (about 9 percent from the level of activity under present law).

We expect that multifamily housing starts will fall by about 230,000 units below the level of construction that would occur with a continuation of present law. The sharpest declines would occur among low-and moderate-income developments which have depended on IDB financing.

The impact of the decline in new construction due to implementation of the President's proposals would include a decline in employment of about 350,000 jobs in 1986.

Property Values

The proposed tax changes would reduce the values of existing properties. For owner-occupied properties, market values would have to decline by about 10% in order to fully offset the reduced tax benefits available for homeownership. However, actual declines are likely to be substantially less, and would probably average about 5%.

For rental properties, the decline in values would be greater. The extent of the decline would depend on investors' expectation of future rent increases. If investors do not anticipate a rent response, resale values of existing properties could decline by as much as 25%. Such large price declines would be most likely in areas subject to rent controls and among low income housing units currently eligible for special tax benefits.

Declines in house values would have an adverse impact on the wealth of homeowners, for whom housing equity typically represents their principal asset. For savings and loan associations and other mortgage lenders, private mortgage insurance companies, and the mortgage insurance and deposit insurance funds maintained by the federal government, a decline in property value could represent a significant risk. Price declines would both increase the likelihood of defaults on mortgages and reduce proceeds that would be available from foreclosure sales.

IV. Conclusion

NAHB has spent a substantial amount of time reviewing the President's tax reform proposals and other proposals that have been introduced. We feel that as the Congress considers tax reform, it should keep in mind certain basic principles:

- Homeownership should be encouraged. Tax changes should not increase the cost of homeownership, particularly for those who are just entering the housing market. Any changes to the tax law should maintain existing property values and should not result in diminishing the value of homeownership -- which often is a family's major investment. Homeownership also is important for the community because it provides for social and political stability.

- Incentives for capital investment, particularly for the construction and ownership of rental housing should be maintained. Moreover, special consideration should be given to low-income housing needs. Incentives directed toward capital formation for rental housing, particularly ACRS depreciation allowances and the use of partnerships as a means of capital accumulation for investment in rental housing should be maintained and strengthened.

- The tax system should foster savings and capital formation. Economic productivity and growth require private capital formation. Thus, incentives to save and invest should remain an integral part of the tax system.

- Reform should facilitate tax compliance with an eye towards fairness and deficit reduction. Reform for the sake of reform is not enough. While the current tax law may be far from perfect, for many taxpayers who use the standard deduction, it is relatively simple. Furthermore, current tax law promotes desirable economic and social goals.

- Frequent changes in the tax law should be discouraged. Tax changes create investment uncertainty. Thus, any future changes should attempt to minimize potential market dislocations. It is essential that there be certainty in order to allow for long-range planning.

Finally, Mr. Chairman, we wonder why the rush for tax reform? Since 1981, three major pieces of tax legislation have been enacted. The Economic Recovery Tax Act of 1981 provided much-needed tax incentives in order to stimulate economic recovery. The Tax Equity and Fiscal Responsibility Act of 1982 cut back somewhat on the incentives provided by the 1981 Tax Act in order to help reduce the Federal deficit. Then, in 1984, the Deficit Reduction Act further cut back these incentives. The 1984 Tax Act will amount to an approximately $8 billion tax increase for housing and the real estate industry through 1987. While we generally support efforts to reduce the deficit, we wonder how much more of the burden real estate and the housing industry will be asked to shoulder.

If there is a general consensus that the tax code must be reformed, we feel that Congress should proceed in an orderly fashion. Tax incentives that have served useful purposes should not be lightly discarded. Rather, they should be studied thoroughly to determine whether or not they are still desirable or are in need of modification. We at the NAHB are willing to work with the Congress to develop a sound tax policy. Again, I thank you for the opportunity to testify and now will be glad to answer any questions you may have.

STATEMENT OF J. McDONALD WILLIAMS, CHAIRMAN OF THE BOARD, NATIONAL REALTY COMMITTEE, DALLAS, TX

Mr. **Williams**. Thank you, Mr. Chairman. I appeciate the chance to appear before the committee. As a general predicate, I would like to emphasize the importance of the real estate industry to our economy as a whole in this country because, as we begin to consider changes in it, I think we have to consider the second, third, fourth order ripple effect that the changes in the tax laws will have as they relate to the productivity of our country. It has been estimated that more than 10 percent of the economic activity of this country is in the real estate development business. More than 10 million people are directly employed in the business, that is, in development business and in the construction subcontractor trades and in the finance business for real estate. And that doesn't count the people indirectly employed, whether it is from the steel companies that manufacture steel for buildings or the timber business, or whether it is the applicance factories in Louisville, KY that make appliances for homes.

We are talking about a huge industry with profound economic effects, I think, on our whole country. And it is our judgment that this bill—the administration's bill—would sharply reduce the level of new construction in this country for some period to come; and second, and perhaps even less importantly, it would reduce the values of current real estate, at least until such time as rental levels could rise. Rental rates are not going to rise soon because of the serious overbuilding problem we have in this country at the moment, which if I may, I would like to come back and speak to. I think it is a fair statement to say that this administration's tax bill has a fundamentally anti-real estate bias to it, and that theme pervades the bill. Somehow there is the idea that real estate is not a productive asset and ought not to be encouraged. Our tax laws ought not to encourage these so-called nonproductive assets. And yet, if you have an office building, is the office building less important to the conduct of the business there than, say, the computers or the furniture or whatever else?

If you are a shopkeeper, is your shop less important to you than your fixtures or your racks or whatever for your goods? If you are a warehouseman, is the warehouse less important to you than the heisters or the racks? I think there is somehow the notion that real estate isn't a productive asset, and that is an erroneous notion. Second, I think there has been the idea that real estate has been too tax favored; and yet, when you compare it with other capital assets, such as equipment and machinery, you find that it is less tax favored in relation to other capital assets. Now, again, it is a different question, of course, to compare it to other forms such as financial instruments. Third, somehow there is the idea that the tax laws are what are responsible for the overbuilding in this country and that that is a problem the idea that real estate is not economic business. The overbuilding in this country is due to a lot of different factors, and is partly due to the tax laws admittedly; but more importantly, I think, it is due to the deregulation of the thrifts. When you see the thrifts go from a negative inflow of capital of, say, $20 billion 1980–81, post Garn and St Germain, to plus

$60 billion last year, from being in third place in terms of financing real estate, the S&L's are now in first place, I think it is a fair statement that most of the overbuilding in this country is due to the profligate lending practices of the thrifts and not the tax laws. Admittedly, some is due to the tax laws. But what the Congress did in 1984 in taking the deep shelter aspects out of real estate investment, such as doing away with deductibility accrued interest and so forth, I think did away with the shelter abuses in the real estate area. To some extent, this bill is taking this problem of the past and trying to throw out the baby with the bathwater in overhauling the whole tax laws. In Houston, TX, for example, today the overbuilding problem is not mainly due to the tax laws and frankly not mainly due to the thrifts, but it is due to the downturn of the energy business. So, I think real estate is getting to be the scapegoat for some things really aren't quite fair to charge them with. To illustrate my thesis that this bill really is anti-real estate: One, it denies long-term capital gain treatment to depreciable real estate. Why? Why should a person be able to sell stock at a 17.5-percent tax but sell depreciable real estate at a 35-percent tax? Second, the elimination of the at-risk exception. Real estate historically has been financed with nonrecourse debt. It is the way it has been done. Treasury's own statements indicate they don't raise a lot of revenue by eliminating at risk. You are going to have people go out of the business and others restructure this approach to financings. Why? What is the reason for this? Third, this retroactive depreciation tax that requires us to go back and redo all the depreciation we have taken for the last 4 or 5 years and pay a penalty tax on the depreciation taken, which was required by the law—not optional, but required by the law in 1981. And by the way, many of us in our industry didn't ask for 15-year depreciation, as you all may recall. We sought longer depreciation, but this is what we got. Now, we are going to be taxed retroactively on that. Fourth, this addition to the alternative minimum tax, requiring us to keep two sets of books on every project we build in the future: One as if Treasury had passed for depreciation, and then two, whatever the new law is—so I think there is fundamentally an anti-real estate bias and frankly an antidebt financing bias, too. Witness the limits on deductibility of interest and eliminating the at-risk exception, as I have mentioned before. In conclusion, if I may, sir, I want to say that real estate is primarily a business of small, local people. There are a few large national developers, but it is basically a local and regional business, highly entrepreneurial, very aggressive, very competitive. These fundamental changes in the tax laws would make us more like England, in my judgment, where they don't have depreciation and you have an anti-real estate atmoshphere over there. You have very high rents, very low productivity, very ugly buildings; and I think fundamental changes in the tax laws here result in require that kind of a situation as well. Thank you, sir, for the time. Have you ever seen an attractive building in London?

The CHAIRMAN. I never did like Westminister. [Laughter.]

Mr. WILLIAMS. OK. Excuse me. Built in the 20th century.

The CHAIRMAN. Thank you. Mr. Moore?

[The prepared written statement of Mr. Williams follows:]

STATEMENT OF THE
NATIONAL REALTY COMMITTEE
ON
REAL ESTATE TAX ISSUES
CONTAINED IN
PRESIDENT REAGAN'S TAX REFORM PROPOSALS

SUBMITTED TO THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 16, 1985

July 16, 1985

NATIONAL REALTY COMMITTEE

Statement

on

1985 Tax Reform

This statement presents the views of the National Realty Committee ("NRC") on the provisions of the President's proposals for tax reform which are of greatest interest to NRC members. The NRC is a non-profit business league which represents a significant and diverse cross-section of the real estate industry and which is concerned with the overall health and growth of that industry. NRC members include owners, developers and operators of all types of real estate throughout the United States.

NRC believes that tax reform should result in a tax system with less complexity, especially for individual taxpayers; lower rates commensurate with a neutral revenue impact; and greater fairness, imposing similar tax burdens on similarly situated taxpayers and providing a "level playing field" for business and industry.

NRC recognizes that a "level playing field" requires the elimination of special tax provisions benefitting one group of taxpayers while disadvantaging all others. A level playing field can be achieved only if all business and industries are subject to a fair determination of their taxable income and pay taxes at comparable rates.

Clearly, the present tax system is far from a level playing field and the changes necessary to reach such a goal would be substantial and have sweeping repercussions. If the goal of a level playing field is adopted, significant changes would be necessary in the present tax treatment of many industries. Such changes should be undertaken in a program which avoids abrupt shifts likely to cause severe economic dislocations injurious to all parties with an interest in, or dependent on, the affected business or industry. Thus, NRC recommends that all significant tax changes include prospective effective dates, grandfather rules and transitional implementation, as appropriate.

Among the substantive changes recommended by the President, there are six of primary concern to NRC. These are proposed changes with respect to (1) capital gains, (2) the recapture of excess depreciation, (3) limitations on the deductibility of investment interest, (4) depreciation, (5) the at-risk rule, and (6) the alternative minimum tax. Each of these six proposals, as well as their cumulative effect on real estate, is discussed below.

1. Capital Gains

The President's proposals would retain preferential tax rates (a maximum of 17-1/2 percent for individuals and 28 percent for corporations) for net long-term capital gains, but would make depreciable property used in a taxpayer's trade or business ineligible for capital gain treatment. Under present Code section 1231, gain on depreciable trade or business property held more than six months is treated as capital gain. Loss on such property is ordinary loss, regardless of its holding period. Under the President's proposals, all depreciable property used in the taxpayer's trade or business and placed in service on or after January 1, 1986, would give rise to ordinary income or loss upon its sale or other disposition. However, the basis of such depreciable trade or business property would be indexed for inflation under the proposed Capital Cost Recovery System ("CCRS"), both for purposes of computing gain or loss on sale as well as for computing depreciation deductions.

CCRS would assign depreciable assets into six classes having recovery periods from 4 to 28 years (with real estate assigned a 28-year period) and would adjust the depreciable basis of such assets for inflation. No inflation adjustment would be made in an asset's first year. Beginning with an asset's second year, inflation adjustments would be allowed annually. Thus, at the end of an asset's second and subsequent years, its unrecovered basis (i.e., its basis as adjusted for the prior year's depreciation) would be adjusted for the current year's inflation and then would be subject to depreciation at the applicable CCRS rate for the asset's classification and year.

Land used in a trade or business would continue to be treated as section 1231 property with net section 1231 gains treated as long-term capital gains and net section 1231 losses treated as ordinary losses. However, the Administration's "Analysis" of its proposed capital gains changes indicates that Treasury is considering reclassifying land used in a trade or business as indexed ordinary income property eligible for inflation indexing on the same basis as depreciable property.

Beginning in 1991, individual taxpayers could elect to index the basis of their capital assets for inflation occurring after January 1, 1991. The election would be allowed in lieu of the preferential tax rates for capital gains and would apply to all capital assets disposed of by the individual for the taxable year. Current law limitations on the deductibility of capital losses would continue to apply to indexed capital losses.

The treatment of depreciable property not used in connection with the taxpayer's trade or business (i.e., investment property) under the President's proposals is not entirely clear. The description of the President's proposals relating to depreciation treats the basis of all depreciable property as being subject to indexing for inflation. This allowance of depreciation on an indexed basis appears inconsistent with treatment of any depreciable property as eligible for the preferential long-term capital gain tax rate. However, the description of the President's proposals relating to capital gains suggests that depreciable property held for investment, as opposed to use in connection with the taxpayer's trade or business, would continue to qualify as a capital asset, giving rise to non-indexed gain or loss on disposition and eligible for the preferential capital gain rates.

Land held for investment, as opposed to use in the taxpayer's trade or business, also appears to continue to be treated as a capital asset giving rise to capital gain or loss and not subject to indexing.

(a) Increased Complexity

For purposes of characterizing gain or loss upon a voluntary sale or other disposition, present law generally divides real property into three classifications: (1) ordinary income or loss property, generally dealer property or inventory; (2) capital assets; and (3) section 1231 property, (real property held for more than six months and used in a trade or business). Property may be eligible for the allowance for depreciation regardless of whether it is category (2) or category (3) property.

The President's proposal would create additional classifications for real property for purposes of characterizing gain or loss, and would provide inflation-indexing for some categories. Under the President's proposals, the classifications for real property apparently would be

(1) dealer property or inventory giving rise to ordinary income or loss;

(2) capital assets on which gain or loss would be treated as capital gain or loss;

(3) capital assets with respect to which, at the taxpayer's election, gain (after 1991) would be inflation-indexed in lieu of being taxed at preferential rates, while losses would be limited under rules similar to present capital loss rules;

(4) depreciable property used in a trade or business giving rise to ordinary income or loss;

(5) depreciable investment property, eligible for preferential capital gains treatment and perhaps the election to index post-1991 gain;

(6) land used in a trade or business, which might be allowed indexation with ordinary income or loss upon disposition; and

(7) land not used in a trade or business giving rise to capital gain or loss and perhaps the election to index post-1991 gain.

This increase in the number of possible classifications for real property would require additional fact and legal determinations and economic choices by taxpayers, thereby complicating their compliance with the tax law and their legitimate calculation of the tax advantages or detriments in situations where elections would be available.

(b) Reversal of Long-standing Section 1231 Policy

For the greatest number of individual real property owners, the elimination of capital gains treatment for section 1231 property would be considered the most detrimental tax change among the President's proposals, resulting in the greatest adverse economic impact.

Capital gain treatment for gains from the sale of depreciable property has been a long-standing tax policy. The General Explanation of the President's proposals claims that "[h]istorically, the availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II." The statement reveals a short-term historical view. In fact, gains from the sale of depreciable assets consistently have been taxed in the same manner as capital assets at preferential capital gains rates for 62 years, since the introduction of preferential rates for capital gains in the Revenue Act of 1922 until the present day, except for a 4-year period between 1938 and 1942.

In the Revenue Act of 1938, the Congress, concerned with the capital loss treatment of huge losses on Depression-era sales of depreciable property, excluded depreciable assets used in a taxpayer's trade or business from the then-existing definition of "capital asset" to allow ordinary loss treatment for such property. By 1942, the Congress became concerned about the administrative difficulties of properly allocating price and basis between two different classes of property when capital asset treatment was provided for land but not for buildings. The House version of the Revenue Act of 1942 addressed this problem by reinstituting capital asset treatment for sales of buildings as well as sales of land. The Senate version, which became the law, substituted Section 1231 treatment (net long-term capital gain and net ordinary loss) for the House approach.

If the President's recommendations on capital gains are enacted in their proposed form, taxpayers and the Internal Revenue Service would be faced with the same difficulties in a greater variety of circumstances arising out of allocations of purchase price between land, buildings, property used in the taxpayer's trade or business and property held for investment as impelled the Congress in 1942 to repeal its brief experiment with such an approach.

(c) Discrimination Against Depreciable Property

Selective elimination of the capital gains distinction, as proposed by the President, discriminates among various investment assets in an unfair and uneconomic manner, creating a "slanted playing field." Unlike machinery and equipment used in a business, business-use rental real estate competes with stocks and other financial assets for the investor's dollar. Clearly, indexing represents a substantial advance in the measurement of real income appropriately subject to taxation. However, the existence of inflation is not the sole justification for the preferential capital gains rates. Indexing basis for inflation does not therefore eliminate all the reasons for maintaining such a preferential rate and does not adequately "compensate" owners of depreciable real property for loss of capital asset treatment.

In addition to ameliorating the effects of inflation, preferential capital gains rates constitute an incentive to promote savings and investment, smooth out the bunching effect resulting from imposing a progressive rate structure on gains accrued over a period of time but realized in a single year, and, most importantly, reduce the so-called "lock-in" effect which results from the practical reality that most capital gains are derived from discretionary transactions. Imposing inordinately high tax rates on discretionary transactions would result in substantially fewer such transactions, with a concomitant loss of government tax revenue and a less efficient market allocation of capital. Under the President's proposals, the maximum tax rate on disposition of depreciable assets would increase 75 percent, from the maximum 20-percent rate provided by present law to a 35-percent rate, only partially relieved by indexing.

The discrimination between capital assets and depreciable property under the President's proposals would be exacerbated by the election allowing individual taxpayers to choose to index the bases of capital assets for inflation after January 1, 1991, in lieu of having their gains taxed at preferential capital gain rates. Investors in stock and financial assets would therefore enjoy an annual choice which would be denied to most investors in rental real property. Fairness dictates the creation of some similar election for real estate investors.

Finally, the General Explanation of the President's proposals contends that capital gain treatment is unnecessary as an incentive for investment in depreciable property, because such an incentive would be provided through the proposed CCRS depreciation allowances. Whatever the merits of this argument may be in connection with personal property, there is no empirical evidence to suggest that a composite

28-year recovery period for buildings and structures represents an "incentive." On the contrary, studies undertaken for NRC indicate that the 40- to 63-year periods alleged by Treasury to represent "real" or "economic" depreciation are grossly excessive, and substantially shorter periods would result in more accurate real or economic depreciation. See Mills and Rosen, Analysis: Real Estate Depreciation and the President's Tax Proposal (Princeton University, June 1985), earlier version reprinted in Tax Notes, Vol. 27, No. 3 at 319 (April 15, 1985). Copy attached as Exhibit A.

2. Windfall Tax on Excess Depreciation

The President's tax reform proposals include a three-year windfall recapture tax on a taxpayer's "excess depreciation" deductions for the six and one-half year period between January 1, 1980 and July 1, 1986. This novel recapture tax would apply even though a taxpayer does not dispose of, but instead continues to hold, the ACRS recovery property for which the excess depreciation deductions were claimed. The proposal would tax the cumulative excess of deducted depreciation during the six and one-half year period, whether claimed on an accelerated or straight-line basis, over the earnings and profits ("E&P") calculation of depreciation for the period by including 12 percent of such excess in the taxpayer's income in the 1986 taxable year, 12 percent in 1987 and 16 percent in 1988. (In the case of real estate, E&P depreciation is determined on a straight-line basis over 35 years for 15-year property and over 40 years for 18-year property.)

Taxpayers whose total depreciation deductions between January 1, 1980, and December 31, 1985, are less than $400,000 would be exempted from this rule. For taxpayers subject to the rule, their first $300,000 of such excess depreciation would be excepted from inclusion in income. The $400,000 threshold and $300,000 exemption would be adjusted for any taxpayer in existence for only part of the 1980-85 period.

The rule would apply to all property placed in service on or after January 1, 1980, and before January 1, 1986, for which depreciation or amortization deductions were allowable under the applicable law.

According to the General Explanation of the President's proposal, this windfall tax proposal is intended to recapture for the Treasury a benefit which taxpayers who claimed ACRS depreciation between January 1, 1980 and July 1, 1986 would not have expected but allegedly would derive if the President's proposed rate reductions are enacted. The General Explanation states that this windfall would benefit such taxpayers in 1986 and later years because their income, including the tax liability which the Treasury considers them to have deferred by claiming such depreciation, would be taxed then at the substantially lower rates of the President's proposal instead of the expected higher rates scheduled under present law. The President's proposal would reduce the top rates from 50 percent to 35 percent for individuals and from 46 percent to 33 percent for corporations.*

The Treasury views ACRS depreciation deductions as creating in effect deferred tax liabilities which become due in the later years of a property's depreciable life after the depreciable property passes its crossover point, that is, when annual depreciation deductions for the property are no longer accelerated but instead are lower than the deduction which would be allowable in the later year had a longer recovery period been followed. At that time, the deferred tax liability, represented by the tax imposed on a taxpayer's higher taxable income, would be determined at the generally applicable tax rates.

The Treasury contends that taxpayers beginning to depreciate property after January 1, 1980 and before January 1, 1986, would have anticipated that the deferred tax liability created by their ACRS depreciation deductions would be taxed in later years after the property's crossover point at the high marginal rates then expected to continue in effect and not at the significantly lower rates recommended in the President's proposal. If lower rates are enacted but no adjustment is made to the rates used in determining the amount of such deferred tax liabilities, taxpayers who claimed ACRS depreciation deductions between 1980 and 1986 allegedly would enjoy an unexpected windfall in the substantial reduction of such "deferred tax liabilities" by application of the lower, "reform" rates. The special windfall or recapture tax is intended to prevent such a windfall (as well as raise needed revenues).

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* The top marginal rate for individuals for taxable years beginning in 1980 and 1981 was 70 percent; it was reduced to 50 percent for taxable years beginning after 1981. For corporations, the top marginal rate for 1980 and 1981 taxable years was 48 percent; it was reduced to 46 percent for taxable years beginning after 1981.

(a) Over-Simplification Creates Gross Inequity

The windfall tax on excess depreciation would impose a grossly unfair tax on real estate, which in present value terms, would be almost three times greater than the liability which would be created if the exact amount of the purported windfall were recaptured in the future years in which it allegedly would arise. To measure accurately the amount of the rate reduction windfall, each taxpayer would have to determine the crossover point for each asset previously depreciated under ACRS, and compute his deferred tax liability for each year in which it arises. His windfall would be the difference between the tax on the deferred tax liability at the originally anticipated higher rate for each year of the asset's remaining depreciable life and the tax imposed under the proposed reduced rates. Such accurate measurements would require affected taxpayers to make complex calculations for many years into the future.

In the interest of simplicity, the President's proposal attempts to create rough justice by using E&P depreciation as a substitute for economic depreciation in measuring the excess depreciation deducted. Instead of requiring that each property's crossover point be determined and imposing the windfall tax in each of the subsequent years, excess depreciation from 1980 until July 1, 1986, would be recaptured and taxed over three years by including a percentage of it in income in each of the three years. For short-lived assets subject to the windfall tax, the additional "recapture" income for 1986, 1987 and 1988 probably would result in net tax liabilities fairly close in amount and timing to those which would have been imposed when the "expected" deferred tax liability created by ACRS depreciation became due under the current regime.

However, not every asset initially depreciated under ACRS and still subject to depreciation after 1985 in the post-reform period would be accorded such "fair" treatment under the President's proposal. Assets placed in service prior to 1980 would be exempt from the windfall tax even if depreciated on an accelerated basis. Such pre-1980 property would enjoy the unanticipated windfall benefit of lower deferred tax liabilities because the liabilities would be determined at the new lower rates without any windfall adjustment. On the other hand, many taxpayers owning long-lived property, especially real estate, subject to the windfall recapture tax in 1986, 1987 and 1988, would owe large additional tax liabilities for those three years, even if the properties' crossover points are still far in the future and their originally "expected" deferred tax liabilities would not have begun until years later.

If the present value of the three-year windfall tax on excess depreciation on real property is compared to the present value of the alleged windfall benefit of lower ordinary rates on the property owners' theoretical deferred tax liabilities to be received many years later, the real economic cost of this tax to most owners would far exceed their "unexpected" future windfall benefits. In present value terms, the windfall tax with respect to a $1-million investment in 15-year real property placed in service in 1981 and depreciated on the straight-line method would be almost three times greater than the liability which would be imposed if the exact reduction in the owner's "expected" liabilities were recaptured in each of the future years when the windfall would occur. See Stretch and Sunley, "Recapture of Excess

Depreciation; What are the Issues?" Tax Notes, Vol. 27, No. 13 at 1501 (June 24, 1985).

Moreover, if the windfall tax is intended to recapture "unexpected" and "unanticipated" tax benefits, its application to real estate is based on a serious misunderstanding of most real property owners' actual expectations. Most owners of real property subject to the tax never expected to realize income from such property which would be taxable at 50-percent marginal rates. They instead anticipated that upon disposition of such property a maximum 20-percent tax would be imposed on any gain. Thus, the proposed rate reduction would produce no significant windfall when property is disposed of at the new 17-1/2 percent capital gains rate.

If the proposed windfall tax is to be defensible in equitable and economic terms, real property (and other long-lived depreciable assets) either should be excepted entirely from it or should be subject to rates far below the 12 and 14 percent rates recommended. Unless real estate is excepted or is provided much lower windfall tax rates, the tax on excess depreciation cannot be characterized as a measure to recoup unintended windfall benefits but must be acknowledged for what it is, a discriminatory tax designed to raise revenue.

(b) Windfall Tax Discriminatory

The windfall tax recapturing the "unexpected" benefit of rate relief on one type of property, that is, ACRS recovery property, would disfavor such property, especially real estate and other long-lived depreciable assets, while allowing owners of other types of property, for example, fixed-income debt obligations, land and royalties, acquired in the same high-rate era, to enjoy the full (and equally unexpected) benefit of the new lower rates. Moreover, the President proposes to recapture only the depreciation windfall attributable to rate reduction and would ignore the windfalls with respect to deferred taxes attributable to deferred compensation plans, retirement benefits, individual retirement accounts ("IRA's"), completed contract accounting, installment sales reporting, rapid amortization and other provisions.

In addition, the windfall recapture tax would have varying effects on different businesses and industries. For example, industries which have experienced losses in years prior to the proposal's 1986 effective date would be able to eliminate any liabilities for the windfall recapture tax by offsetting their liability for it with net operating loss carryforwards. Conversely, businesses which have paid high tax liabilities would be heavily burdened by this proposal.

(c) Unprecedented Retroactivity

The argument that the Treasury should be entitled to recapture "unexpected" windfalls to be received by taxpayers with respect to ACRS recovery property if the President's proposal is enacted is unprecedented and dangerous. It generalizes without foundation about taxpayers' intentions and expectations. It would freeze or "lock-in" a taxpayer's treatment under the tax law as of the date of the taxpayer's action or investment, while imposing no such stricture on the government. It has not been customary for tax legislation changing general tax rules to grandfather under prior rules subsequent income derived from earlier investments. For example, when accelerated depreciation was made a minimum tax preference, the change was not limited to depreciation with respect to property placed in service after the new preference item's effective date.

The President's proposal for a windfall tax on excess depreciation would constitute a radical departure from long-standing tax policy. It would prove complex and discriminatory. For the real estate industry in particular, it would create unfair, significant economic distortions and difficulties.

3. Limitation on Interest Deductions

The President proposes to tighten the present law limitations on the deductibility of investment interest by expanding the scope of the limitation to encompass all interest other than certain business interest claimed as an itemized deduction (except interest on a mortgage on the taxpayer's principal residence), including interest on consumer loans, a passive shareholder-taxpayer's share of interest expense of an S corporation and a limited partner's distributive share of all of the limited partnership's interest. Interest on indebtedness for business rental property also used for personal purposes would be treated as business interest not subject to the limitation only in the proportion that the number of days such property is rented at fair rental bears to the number of days in the taxable year.

The proposed rule would deny a taxpayer's consumer, investment, and certain business interest deductions (other than mortgage interest with respect to the taxpayer's principal residence) to the extent that they exceed the sum of (1) the taxpayer's passive investment income and (2) $5,000. Disallowed interest deductions could be carried forward and deducted in the succeeding taxable year, subject to the limitation for that year. However, no carryover is allowed to the extent the disallowed interest for a taxable year exceeds overall taxable income for that year.

"Passive investment income" would include dividends, interest and income from limited partnership interests and with respect to shareholdings of a passive shareholder in an S corporation. Excluded from passive investment income would be business income from general partnership interests, sole proprietorships and S corporations managed by the taxpayer.

"Net investment income" would be determined by deducting certain "investment expenses" from passive investment income. Expenses deductible for this purpose include trade or business expenses (section 162), property taxes, bad debts, straight-line depreciation over the property's estimated useful life, and expenses for the production of income (section 212), provided such amounts are directly connected with the production of investment income.

Property subject to a net lease would be treated, as under present law, as held for investment if the lessor's section 162 trade or business deductions with respect to the property for the year are less than 15 percent of the rental income from the property, or if the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income. For purposes of the 15 percent, a taxpayer could elect to treat as leased under a single lease a parcel of property which is leased under two or more leases. In addition, real property which has been in use more than 5 years could be exempted by election from the 15-percent test. However, the proposal would repeal the present law tax rule which permits taxpayers to deduct actual investment expenses in excess of income from property subject to a net lease. As a result, the President's proposal, in some circumstances, would deny deductions for out-of-pocket losses, i.e., actual cash interest payments in excess of the rental income from net-leased property.

The proposal would apply to interest paid or incurred in taxable years beginning on or after January 1, 1986, subject to two phase-in provisions. First, for taxable years prior to January 1, 1988, the limitation would be $10,000 plus net investment income. Thereafter, the limitation would be $5,000 plus net investment income. Second, interest expense made subject to the new limitation but not subject to the present law limitation would be included gradually under the new rule at a rate beginning at 10 percent of such interest per year in 1986 and increasing by an additional 10 percent per year thereafter, until fully phased-in 1995.

(a) Interest Limitation is Draconian

The expanded limitation on interest deductions has been proposed as a means of curtailing tax sheltering through "tax arbitrage" transactions whereby taxpayers use borrowings on which deductible interest yields tax benefits at ordinary rates, to invest in property giving rise to tax-preferred income, e.g., capital gains. This anti-shelter rationale, however, is flawed. The limitation would affect interest associated with activities and investments which would not be ordinarily considered tax shelters. By further limiting the deductibility of interest, the proposal would make real estate operations more expensive and less attractive to investors, while forcing rental charges upwards and burdening tenants. Some taxpayers might never be able to deduct disallowed interest expense. Because "net investment income" does not include long-term capital gains, it is unlikely that all carryover interest expense would be allowable in the year of sale. Some of such disallowed interest probably would be permanently lost. Moreover, because the limitation applies only to individuals, the proportionate participation of corporations in real estate would be likely to increase; the participation of individuals, to decline.

Thus, the proposal would adversely affect many customary real estate transactions and investments. Denying interest deductions would reduce capital available for real property. Real estate values would decline because real estate traditionally has been a debt-financed investment. The retroactive adverse effect of the proposal on existing investments would be considerable, even with phased-in application, because investors would lose formerly fully deductible interest payments and would hold property made less attractive to the investing public generally.

(b) Proposal's Rationale is Inconsistent

The President's explanation of the expanded limitation on interest deductions contends that the new rules are needed because the present law unlimited deduction for consumer interest and for "passive" business interest deducted on a pass-through basis by limited partners and inactive S Corporation shareholders permit avoidance of present law limitations on such tax-arbitrage transactions as borrowing to purchase tax-exempt bonds. Because money is fungible, the determination of the purpose of an indebtedness, as required by present law, is difficult. The President's proposal, so it is argued, would make the determination of whether debt was incurred for a nondeductible purpose less difficult.

The proposed limitation on interest deductions probably would not significantly decrease the difficulty of determining whether money borrowed for an ostensibly deductible purpose is in fact borrowed for a nondeductible purpose because the unchangeable source of the problem remains: money is fungible. Even under the President's proposal, taxpayers may attempt to use mortgages on their residences and borrowings in connection with their active businesses for nondeductible purposes, e.g., limited investments in tax-preferred oil and gas partnerships. Wealthy taxpayers with valuable residences and businesses could easily arrange such financings. Moreover, wealthy individuals could transform the passive nature of their investments, while minimizing their risk through insurance guarantees and indemnities, by changing their limited partnership interests into interests as general partners and by assuming some active responsibility for the affairs of their S Corporations. Clearly, even though the proposed limitation on interest deductions would lessen some present law difficulties of tracing funds and classifying activities, the proposal would create new definitional and tracing difficulties and give rise to new forms of tax avoidance.

(c) Interest Limitation Proposal Would Deny Deductions for Actual Losses

The interest limitation rule would deny some deductions for interest expense where real losses are being suffered by taxpayers. Under present law, taxpayers are permitted to deduct the full amount of actual investment expenses in excess of income from property subject to a net lease. The President's proposal would repeal the deductibility of such out-of-pocket losses, causing severe economic problems for real estate investors. If this proposal is enacted, it should be amended to allow deductions for out-of-pocket losses.

(d) Proposed Limitation on Interest Deductions Favors Existing Wealth

Tightening the limitations on the deductibility of interest would discriminate in favor of the wealthy and would disadvantage potential, new investors. The President's proposal would make investing more difficult for taxpayers who must borrow to make capital investments without denying investment opportunities (and perhaps making them more available) to wealthy individuals who have substantial cash and assets for equity investments and have significant investment income to offset large interest deductions. By significantly reducing the viability of leveraged investments, especially for assets such as real estate which typically are highly leveraged, the proposal favors the wealthy over other taxpayers. And, by permitting interest deductions only to the extent of net investment income plus a specified amount, it favors taxpayers who already are investors receiving investment income over potential new investors whose earnings cannot be reduced by investment interest deductions. In addition, as a result of the President's interest limitation proposal, individual participation in real estate investment would decrease and the market power of pension funds, corporations and other institutional owners not subject to the limitation would increase.

(e) Interest Limitations Would Have Unprecedented Retroactive Effect

The new limitations on the deductibility of interest would apply without exception to interest on all debts incurred prior to the enactment of the President's proposal. Even with the new rule's gradual implementation, the limitations would create unanticipated economic hardship for owners of debt-financed real property who prior to the proposal's passage became obligated for such debt on the basis of the then-existing law. Prior legislation limiting interest deductions generally excepted from new rules all debt incurred prior to the legislation's adoption. Particularly with respect to the special rules for net-leased property, changes have been prospective, applying only to debt incurred after the date on which the change was adopted in committee or after enactment.

If the proposed interest limitations are enacted, they should apply only prospectively.

4. Depreciation

The President's proposals include a new Capital Cost Recovery System ("CCRS") which would assign all depreciable property to one of six classes with recovery periods between 4 and 28 years. Real property would have a 28-year recovery period. An inflation adjustment would be made annually to depreciable property's basis for its second through its final recovery year after the basis had been reduced by the prior year's depreciation allowance. The new depreciation schedule would begin with a declining balance depreciation rate and would switch to a straight-line rate in the year in which the straight-line rate would provide a higher depreciation allowance than the declining balance method.

(a) Real Estate Depreciation Should Reflect Current Lives

A depreciation schedule ideally should be based on the actual decline in the real value of property. However, determining the real or economic rate of depreciation, particularly the proper rate for real property, is difficult. The rate for buildings placed in service in 1985 should reflect the future life expectancy of such buildings. Accurate predictions of the future, of course, are hard to obtain.

Most studies of depreciation, particularly depreciation of real property, are based on historical data. Such data alone is inadequate for estimating an asset's appropriate depreciable life. Historical data provides only a limited and irregular set of values, which generally are based on sales prices of property and not on annual appraisals of the existing stock of real property. In addition, this relatively sketchy data base reveals little about the significance of variations among buildings.

Historical data is based on information about buildings placed in service years ago. Thus, it does not take into account factors which have changed buildings and their economic lives over the years. Present construction requirements and life expectancies probably differ greatly from those of the first half of this century. Today, the cost of components generally constitutes a greater percentage of the total cost of constructing a building than does the cost of erecting the building's shell. Such components suffer physical decline much faster than a building's external structure and become obsolete much faster than its structure because of the demands of new technology. Thus, the real or economic rate of depreciation for new real property probably is much faster than the rates experienced by older buildings. See Mills and Rosen, Analysis: Real Estate Depreciation and the President's Tax Proposal (Princeton University, June 1985), earlier version reprinted in Tax Notes, Vol. 27, No. 3 at 319 (April 15, 1985). Copy attached as Exhibit A.

(b) Real Property Depreciation Should Be Fair

In order to establish and preserve a level-playing field for investment, the capital cost recovery schedules assigned various categories of depreciable property should be fair or "neutral" in relation to the schedules assigned to other categories of depreciable assets. If the recovery schedule assigned to other categories of depreciable assets. If the recovery schedule assigned real property is overly long in comparison to the schedule provided for equipment, the playing field, which has been tilted in favor of investments in equipment, will continue to disfavor and discourage investment in real property. Such bias should be avoided.

(c) Basis Indexing Necessary

The President's proposals would help greatly to overcome an indirect but serious current law bias against real property. By adjusting the basis of depreciable property for inflation, property owners would be allowed to recover their full economic investment in property, not just the property's cost. Under present law, the lack of such an adjustment is particularly harmful to real property. The effects of three or five years of average inflation on a short-lived asset are not so serious as the effects of even lower inflation over the long recovery provided for real property. The inflation adjustment in CCRS should be included among any depreciation amendments adopted by the Congress.

5. Application of At-Risk Rule to Real Estate

The President's proposals would extend the present law at-risk rule to real estate activities. The at-risk rule limits an individual taxpayer's deductions with respect to an activity to the amount of the taxpayer's actual investment in the activity, i.e., his amount "at-risk". The at-risk rule applies on an activity-by-activity basis. The amount at-risk generally is the sum of the money invested in and property contributed to the activity by the taxpayer plus any funds borrowed for the activity for which he is personally liable (i.e., his share of "recourse" borrowings, if any.) A taxpayer is not considered at-risk with respect to amounts protected against loss through nonrecourse financing, guarantees and stop-loss or similar arrangements. Losses disallowed under the at-risk rule can be carried forward and deducted in later years when the taxpayer's amount at-risk in the loss-generating activity increases. In addition to individuals, the at-risk rule also applies to estates, trusts, personal holding companies and certain closely-held C corporations. Regular C corporations are exempt.

(a) At-Risk Rule Would Change Customary Real Estate Financing

The application of the at-risk rule to real estate, proposed as an anti-tax shelter measure, would affect most real estate activities and investments, not just tax shelters, because nonrecourse financing is the customary method of financing real property. Unlike the use of nonrecourse financing in other activities, such as oil and gas drilling and film production, where such financing is obtained to exploit its tax shelter potential, nonrecourse financing of real property, albeit tax-advantaged, has been used throughout the real estate industry and not merely in tax shelters. Lenders have long been willing to make nonrecourse loans for real estate, looking only to the financed property for security. Nonrecourse financing enables small- and medium-sized developers and investors to participate in real estate investments. Application of the at-risk rule to real estate would limit the use of nonrecourse financing and would reduce small- and medium-sized developers' and investors' participation in real estate. Many potential investors effectively would be denied entry into the real estate market, with adverse consequences for all segments of the real estate industry.

Although the dimension of the at-risk rule's adverse impact on real estate would depend upon the enactment of, and its interaction with, other proposals affecting real property, the adverse impact of the at-risk rule could be severe. In any event, it would be likely to alter the well-established practice of using nonrecourse loans for real estate financing. The tax system would be determining and changing economic relationships and business transactions.

Application of the at-risk rule to real estate would make real estate activity more expensive, would reduce new investment, would reduce the value of present real estate holdings and would result in rent increases. In addition, the at-risk rule would significantly complicate tax computations for real estate activity, causing increased accounting and legal expenses and greater uncertainty and error with respect to tax liabilities. This change would provide an incentive to churning because taxpayers would wish to sell their real property before their amounts at-risk decline to zero.

(b) At-Risk Policy Should not Prevent Related-Party Financing

In the "Analysis" of the at-risk proposal, it is suggested that the proper purpose of an at-risk rule may not be to prevent the deduction of artificial losses but instead to police the use of limited-risk financing to inflate values artificially and thereby to create an artificially high depreciable basis in the financed property. A rule implementing the latter policy would limit a taxpayer's basis in property financed with nonrecourse debt. Because it is assumed that unrelated, institutional lenders would obtain expert, independent appraisals of property for which they make nonrecourse loans, they would not need to be subject to the basis restriction. Instead, the transactions with greater potential for abuse, particularly nonrecourse financing obtained from a related party, would be the object of such a rule. The discussion in the Analysis suggests that owners of property with nonrecourse financing from a related party would be suspect and implies that their basis in such property should be reduced if such related party nonrecourse financing exceeds some unspecified percentage of the basis claimed.

Such a rule would have a disproportionate impact on real estate compared to other investments because nonrecourse purchase-money financing is so frequently used in real estate transactions. Eliminating or limiting the utility of such financing in real estate transactions could cause significant "lock-in" in the real estate market. Moreover, the Internal Revenue Service already has adequate legal authority to deny deductions with respect to artificially inflated values. See, e.g., Estate of Franklin, 544 F.2d 1045 (9th Cir. 1976), aff'g, 64 T.C. 752 (1975). Note should also be taken of the substantial changes in the imputed interest and original issue discount rules made by the Tax Reform Act of 1984, the full impact of which has not been felt. Therefore, as a legal matter, additional basis-reduction rules are not needed.

Moreover, reducing the basis of property merely because nonrecourse related-party financing constitutes an arbitrary percentage of the claimed basis would be extremely harsh and would rigidly limit the amount of nonrecourse financing which a taxpayer could use to acquire a property regardless of the property's real value and the taxpayer's equity investment in and personal liability with respect to the property. Clearly there is less likelihood of tax-shelter abuse, either through "artificial losses" in excess of equity and personal liabilities or through basis-inflation by means of related-party financing, in cases where a property owner is "at-risk" with respect to a significant percentage of basis on account of his cash investment in, and/or personal liability with respect to the property, than in cases where there is no significant cash equity and/or personal liability. Thus, if some administrative simplification is required, it might better be provided by creating a safe-harbor from any disallowance of deductions (whether on grounds of artificial losses, inflated basis, or both) in cases where a specified percentage of the basis of real property is attributable to cash and/or recourse debt.

(c) At-Risk Rule Would Limit Capital Investment

Application of the at-risk would limit the capital available for investment in real property. Money now available for investment on a nonrecourse basis might be withheld in the future by investors unwilling to assume personal liability with respect to the construction or acquisition of real estate. In addition, new funds for investment would be reduced because new entrants into the real estate market, especially small- and medium-size developers and investors, could not undertake the risk associated with recourse debt. The real estate market would become less liquid and a much greater percentage of real property would be concentrated in the hands of wealthy individuals and in regular corporations not subject to the at-risk rule.

6. Alternative Minimum Tax

Under present law, the alternative minimum tax ("AMT") on individuals is the excess of

(1) 20 percent of alternative minimum taxable income ("AMTI") (excluding an exemption of $40,000 for joint returns, $30,000 for single persons and heads-of-household, and $20,000 for other noncorporate taxpayers), over

(2) the regular income tax.

This tax is imposed in addition to the regular tax, so that an individual's total income tax burden is his regular income tax plus his AMT, if any.

In determining AMTI, certain tax "preferences" are added back to income. In the case of pre-ACRS real property, the difference between accelerated depreciation and straight-line depreciation over the same period is a preference. In the case of ACRS real property, the difference between ACRS deductions and straight-line deductions over the prescribed ACRS recovery period is a preference. Also, subject to the AMT is the preference accorded net capital gains.

Under the President's proposals, the threshold AMT exemption would be changed to $15,000 for joint returns ($7,500 for separate returns), $12,000 for heads of households and $10,000 for single persons. Also, the first $10,000 of preferences would be excluded from AMTI.

The President's alternative minimum tax proposal would retain the preference treatment provided under present law with respect to depreciation of pre-ACRS real property and real property which is recovery property, as well as the net capital gains preference. However, it would calculate the depreciation "preference" with respect to real property placed in service on or after January 1, 1986, on a more stringent basis. For real property placed in service on or after January 1, 1986, the AMT preference would be the amount by which the depreciation deduction claimed under the new Capital Lost Recovery System ("CCRS"), whether on an accelerated or straight-line basis, exceeds the deduction which would be allowable if the property had been depreciated under the "economic" depreciation system originally proposed by the Treasury in its tax reform recommendations, i.e., over a "real" economic, 63-year life.

(a) Preference Proposed for CCRS Real Property is Excessive

The AMT preference treatment for real property placed in service in 1986 and subsequent years under the President's proposals would be excessive. It assumes that the 63-year recovery period originally proposed by the Treasury in its recommendations is equivalent to the real economic life of real property. The validity of this assumption has been strongly disputed. It is based on a flawed study. Even its Treasury proponents have admitted that the study is not definitive. The "real" economic life of real property is uncertain. At most, it appears that the real life of recent, new construction is far below 63 years. Components now constitute a far greater percentage of the investment in the construction of a new building than does the building's shell. And, unlike the shell, components have a relatively short life and must be replaced at an early date because of their actual physical deterioration and changing technological requirements.

The life of real property on a composite basis appears to be at most, and possibly significantly less than, 29 years. Thus, treating the difference between depreciation over 63-years and CCRS depreciation, especially straight-line

CCRS deductions, as a preference would far overstate any tax benefit attributable to CCRS real property.

The real property preference proposed by the President would require burdensome recordkeeping and calculations for real property owners and would disproportionately increase the tax burden on real property, thereby reducing its marketability.

7. President's Proposals on Real Estate Create Overkill

Some major changes must be made to alleviate the potentially disastrous impact of the President's proposals on real estate. In addition to the changes discussed above, the President would deny tax exemptions for industrial development bonds, ending an incentive vital to rental housing; would repeal the rehabilitation credit, which made many urban real estate improvements feasible; and would end 10-year amortization of construction period interest and instead require its capitalization, thereby increasing the cost of new construction. All these proposals, when added to the tax amendments enacted in the Deficit Reduction Act of 1984 which have not yet fully filtered through the real estate market, would be economically devastating. The interaction of any tax measures which are to become law with each other and with present law provisions must be thoroughly evaluated to insure that they are effective without creating overkill. The preliminary results of a study conducted by Price Waterhouse on the possible impact on real estate investment of the President's tax proposal is summarized in the attached Exhibit B. In particular, NRC urges that

(1) the Congress retain capital gains treatment for depreciable real estate;

(2) all interest expense for real property continue to be deductible as under present law;

(3) the AMT preference treatment for post-1985 real property investment be scaled back to apply only to accelerated component of CCRS depreciation over the post-1985 CCRS recovery period;

(4) depreciation changes be fair, reflect current construction's life and include basis adjustments for for inflation;

(5) the windfall recapture tax on excess depreciation not be adopted; and

(6) the present law exception of real estate from the at-risk rules be preserved.

STATEMENT OF WILLIAM M. MOORE, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Mr. MOORE. Thank you, Mr. Chairman and members of the Senate Finance Committee. My name is Bill Moore, from Denver, CO, serving as first vice president of the National Association of Realtors this year. On behalf of more than 650,000 members of our association, we, appreciate the opportunity to present our views to you this morning. The realtors of America regard the budget deficit as the most serious public policy issue impacting the welfare of our Nation's economy, and we frankly believe that Congress should enact a real deficit reduction as its first priority. We support the President's goal of fairness, simplicity, and economic growth; however, we believe the administration's proposal does not really achieve these goals. We join with those who fear the administration's proposal would increase the budget deficit, could retard growth in the long run, and lead to a recession in the short run. We do not believe the plan is simple or fair to taxpayers, homeowners, renters, savers, or investors.

As currently written, the plan discourages homeownership because: First, the proposed elimination of the deduction for State and local property taxes would raise the after-tax cost of a home by about $400 for the average family. This, we feel, would likely result in a 5-percent decline in home value, which is equivalent to approximately a 10-percent loss in the lifetime savings of the typical homeowner. Second, the proposed $5,000 limit on deductions for all investment interest, including interest on second home mortgages, would harm primarily middle income second homeowners and would deal a severe blow to hundreds of local communities that depend heavily on the resort, recreational, and other second home activity. Even the anticipation of such a provision is already causing cutbacks in job-creating construction and in loss of home values in a number of second home communities in many States. And finally, the proposed elimination of the mortgage revenue bond program will thwart the ability of lower income families to become homeowners, especially during high interest rate periods. And since 1982, the mortgage revenue bond program has made it possible for more than 500,000 lower income families to become homeowners. An unfair and unwise burden of taxes will be imposed on rental housing and commercial real estate investment, thus, in our opinion, increasing rents, creating rental housing and other real estate shortages, and reducing employment. This will occur because of the retroactive collection of taxes, on previous depreciation deductions, which is triggered without the occurrence of any event providing the cash to pay the new tax. This "windfall recapture" provision is totally unfair, and we think it will result in less cash for job creating investments. The unwise extension of the at-risk rules to real estate fail to recognize the measurable value of real estate in comparison with nonreal estate investments. It would reduce investment, particularly from smaller investors. Potential abuses in lending practices can be eliminated by requiring arm's length loans in order to qualify for the at-risk exception, which Treasury has suggested. The $5,000 limits on the deductibility of passive net investment interest would reduce investment, particularly by small investors who don't have other outside investment income to offset these investment interest costs. The reduction in depreciation allowances and the complication of indexing the base and the discriminatory setting of a tax 40 to 50 percent higher on all real estate structures and equipment would reduce investment. The change in the capital gains treatment for structures and the unpredictability of value caused by indexing could lead to unequal treatment for depreciable in comparison to other long-time investments, and could place housing and structures at a disadvantage in comparison to passive purchases of stock and bonds. We urge that there be no net tax increase on savings, investment, and home ownership. Net tax increases should be aimed at what people consume, not at their savings and investment needed for growth and jobs and income. In conclusion, our message is rather simple. Deficit reduction of $50 billion or more must be adopted first. And let me make it abundantly clear that our association stands ready to help and do our share in working toward a deficit reduction and a balanced budget. Tax changes should foster economic growth and thus should encourage not discourage, more savings and investment and home ownership. Thank you.

The CHAIRMAN. Thank you, Mr. Moore. Sheldon Cohen, the former Commissioner of the Internal Revenue Service.

[The prepared written statement of Mr. Moore follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
THE IMPACT OF THE PRESIDENT'S TAX PROPOSALS
ON HOUSING AND REAL ESTATE
before the
SENATE FINANCE COMMITTEE
by
WILLIAM M. MOORE
July 16, 1985

I. Introduction

I am William M. Moore from Denver, Colorado, First Vice President of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 650,000 members of the NATIONAL ASSOCIATION OF REALTORS®, we appreciate the opportunity to present our views on the impact that the President's tax proposals would have on real estate and the overall economy.

We regard the tax increase and tax decrease proposals contained in "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity" to be a revolutionary piece of legislation with the potential for dramatic impacts on the economic well being of our country. However, before presenting our views in general on tax revision and our detailed economic analysis of the President's proposals, we feel compelled to state that, in our view, the most significant issue facing our country today is not tax reform but soaring, uncontrolled federal budget deficits which are a darkening cloud on this nation's economic horizon.

II. Overview

- Changes in tax law should promote capital formation which is essential for economic growth and international competitiveness. The Reagan Administration asserts that their proposal will promote more rapid economic growth. However, our analysis as well as that of numerous other analysts demonstrates that the President's proposal finances a cut in personal tax rates by increasing taxes on all forms of investment. The result of this shift in tax burdens would be a change in the composition of Gross National Product (GNP) toward consumption and away from investment. This lower level of capital formation would result in slower growth of the economy, slower growth of labor productivity, and lower living standards for the average American family. (See Appendix A)

Table 1

Impacts of the Reagan Tax Proposals
(% Change from Baseline Except where Otherwise Noted)

	1986	1987	1988	1989	1990	1995
Real GNP	- 0.2	- 1.0	- 1.0	- 1.3	- 1.3	- 0.5
Income Per Household (85 $'s)	-$50	-$200	-$320	-$510	-$730	-$900
Employment	0.0	- 0.5	- 0.6	- 0.5	- 0.5	- 0.1
Labor Productivity	- 0.2	- 0.5	- 0.6	- 1.0	- 1.2	- 1.8

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

- Tax revision should not increase the Federal deficit! The Treasury Department has testified that the President's proposal is revenue neutral or that it raises the same amount of federal revenues as current law and so would not add to the deficit. However, the Treasury Department's own projections indicate that the proposal would raise $12 billion less than current law over the first five years after enactment. Moreover, Treasury officials have conceded that their revenue estimates could be off by 10 percent or about $70 billion in the first years after enactment rising to $100 billion in five years. Further static analysis by the Congressional Budget Office has revealed that, using more realistic inflation assumptions than those used by the Treasury Department, the President's proposal would raise $23 billion less than current law over the first five years of enactment with possible larger shortfalls in later years. Even if the Treasury's static revenue estimates were correct, dynamic analysis indicates that the annual deficit could increase as much as $30 billion per year in 3 to 5 years after enactment due to slower growth of the economy, adding another $100 billion to the federal debt in five years. (See Appendix A)

Table 2

Impact of Reagan Tax Proposals on Federal Revenues
and the Deficit
(Percent Change from Baseline Except where Otherwise Noted)

	1986	1987	1988	1989	1990	1995
Federal Revenues	- 0.6	- 2.5	- 2.8	- 3.0	- 2.9	- 5.2
Personal Tax	- 6.7	- 7.5	- 8.0	- 7.4	- 7.4	- 7.2
Corporate Tax	31.0	16.1	17.9	16.7	21.0	1.6
Federal Deficit	2.6	13.1	16.3	17.5	17.2	37.5
Dollars (Billions)	5	24	28	31	30	73
Cumulative Dollars (Billions)	5	29	57	88	118	390

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

- Tax revision should end the current tax discrimination against long-lived assets such as structures. The Reagan Administration has traditionally endorsed the notion of tax neutrality where income from all types of assets faces the same effective tax rate. Nonetheless, it is clear that under the Reagan proposal the tax code would continue to favor short-lived assets, such as equipment, and disfavor long-lived assets, such as rental housing and commercial structures. By Treasury's own calculations the effective tax rate on structures would be 40 to 50 percent greater than the effective tax rate on equipment.

Table 3

Effective Tax Rates on Equity Financed Investments

	All Capital	Inventories	Equipment	Structures	Greater Tax Burden for Structures Compared to Equipment
Current Law 1/	35%	46%	-4%	39%	—
Treasury I	26%	27%	25%	26%	4%
Reagan Proposal	25%	32%	17%	24%	41%

1/ Assumes 5% inflation, 5 year depreciation period and the investment tax credit for equipment, and an 18 year depreciation period for structures.

Explanatory Note: Assuming all equity financing and that the investment is held for its full useful life, the effective tax rate for equipment would rise under the Reagan proposal while the effective tax rate on structures and inventories would fall. However, structures would continue to be taxed at least 40 percent more heavily than equipment (24 percent versus 17 percent). Actual effective tax rate will vary depending upon the holding period of the investment, the extent of debt financing, and the actual tax rate of the investor.

SOURCE: The President's Tax Proposal to the Congress For Fairness, Growth, and Simplicity, Table 7.01-13, page 159, May 1985.

- Tax revision should provide greater incentives for saving. The Reagan Administration states that their proposal would promote a higher savings rate through lower marginal tax rates and an increase in the maximum spousal IRA contribution to $2,000. However, several business leaders and economists have concluded that there are many anti-saving features of the President's proposal including increased taxes on investment, lower maximum contributions on 401K and other voluntary contribution pension plans, and the taxation of the "inside build-up" of life insurance policies. In fact, the national savings rate is likely to decline significantly under the Reagan proposal, offsetting the impact of lower marginal tax rates and forcing interest rates higher than they otherwise would be. (See Appendix A)

Table 4

Impact of Reagan Proposal on Selected Interest Rates
(percentage point change)

	1986	1987	1988	1989	1990	1995
Effective Mortgage Rate	0.22	0.35	0.37	0.41	0.45	0.77
Aaa Bond Rate	0.20	0.29	0.31	0.36	0.39	0.72
3 Month T-Bill Rate	0.17	0.25	0.27	0.28	0.33	0.66

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

- Tax revision must be adopted gradually and provide extensive transition rules. A number of economists, including Martin Feldstein, a former chairman of President Reagan's Council of Economic Advisors, have testified that the anticipation of tax changes has already distorted investment decisions and that if the President's proposal were enacted, there is a strong likelihood of a recession in 1986. Faced with elimination of the investment tax credit (ITC), investors in equipment are encouraged to accelerate their investment spending into 1985. This is providing an added boost to the economy now but is likely to be followed by a sharp drop in equipment investment in 1986. Investors in long-lived assets are already scaling back their investment plans in anticipation of greater taxes on long-life assets and losses of greater than 10 percent on existing assets from the Administration's proposal.

  Importantly, we support the suggestion of a slow phasing-in of tax decreases and increases. While some transition rules are provided in the President's plan (for example, the "10 year" phase in on the interest deductibility limit), these are far from adequate to protect previous investment decisions, whether already completed or substantially in the works. An incremental approach to tax revision is prudent and responsible. One need only reflect on the events surrounding recent changes in the tax law relating to automobile record keeping and imputed interest to appreciate the potential problems that could result from sweeping changes in the tax code.

- A revised tax code should not discourage homeownership. The Administration is proposing to repeal the deductibility of state and local taxes, arguing that under the current system high tax states are subsidized by low tax states. Further, the proposal would repeal the tax-exempt status of mortgage revenue bonds on the grounds that such bonds benefit private individuals rather than the public at-large and that they erode the income tax base and raise the interest rate on bonds issued for truly public purposes. (See Appendix B)

  Our analysis finds that the loss of property tax deductibility would raise the annual after-tax cost of a typical $85,000 home by about $400 or about 5 percent. This increase in after-tax cost could result in a loss of value of the property of about 5 percent, eroding the average homeowners life savings by 10 to 15 percent. (See Appendix C)

  The impact on after-tax homeownership costs and on home values will vary from state to state depending upon the states average home price and property tax rate. (See Appendices D, E and F) For example, in New Jersey average after-tax homeownership costs would rise by about $920, causing a loss in value of the average priced home of about $9,700. In contrast, in Lousiana average after-tax homeownership costs would rise just $20, resulting in a loss in value of about $270.

Table 5

Determination of the Impact of the Loss of Property Tax Deductibility on the After-Tax Cost and Value of an $85,000 Owner-Occupied Home

	1986 Current Law	1986 Current Law Without Property Tax Deduction	Full Reagan Proposal	Loss of Property Tax Deductibility as a Percent of Total Impact
Before Tax Cost ($)	$10,540	$10,540	$10,540	
Tax Savings ($)	1,664	1,292	726	
After Tax Cost ($)	8,876	9,248	9,814	
Change in Cost ($)	—	372	938	40%
Change in Cost (%)	—	4.2%	10.6%	
Change in Value ($)	—	-3,791	-8,633	44%
Change in Value (%)	—	-4.5%	-10.2%	

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

It should also be noted that nearly 90 percent of tax returns claiming real estate property taxes as an itemized deduction are joint or other family returns, while over 60 percent also claim dependent exemptions. (See Appendix G) Thus repeal of property tax deductibility is an anti-family proposal.

Also alarming is the fact that a typical homebuyer would find his federal tax burden rise under the Administration's proposals, further discouraging homeownership. For example, a typical middle-income two-earner family of four that recently purchased a home would find their federal tax burden rise by about $330 or 15 percent under the full Reagan proposal. In contrast, if the same family rented their home they would likely see their federal tax burden fall by about $740 or 20 percent. Thus, the Administrations proposal would likely result in a continued decline in the homeownership rate in this country, driving us into a nation of tenants. (See Appendix H)

Table 6

Impact of Full Reagan Proposal on Federal Tax Burden of Typical Middle-Income Two-Earner Family of Four

	Homeowner		Renter	
	($'s)	(%)	($'s)	(%)
Federal Tax Burden	+332	+15	-740	-20

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

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- Mortgage revenue bonds provide a countercyclical effect during periods of high interest rates. During the 1982-1984 period, MRBs helped over 500,000 families with incomes typically below $30,000 to become homeowners. These individuals likely could not afford to own their own home at the then high interest rates. Even at today's lower interest rates loss of mortgage revenue bond financing would raise the after-tax cost of a $50,000 home by 17 percent or $840 while the full Reagan proposal would raise that cost by 21 percent or over $1,000.

Some mechanism should exist to improve the ability of lower income people to become homeowners. Outright repeal of the program is too far-reaching. Also, some sort of economic trigger mechanism, such as the applicable federal rate or interest rate, could be implemented that will determine when MRBs are issuable. This will preserve the necessary countercyclical effect to high interest rates that MRBs provide.

At the very least, the mortgage credit certificate (MCC) should be preserved since it was just recently implemented and no bond issuance is necessary for its implementation. Instead of an agency issuing tax-exempt bonds to provide below-market rate mortgages, MCCs can be issued that allow the homebuyer a tax credit.

Table 7

Impact of Loss of Mortgage Revenue Bond Financing and Property Tax Deductibility on the After-Tax Cost of a $50,000 Home 1/

	1986 Current Law with MRB Financing	1986 Current Law W/O MRB Financing	1986 Current Law W/O MRB Financing and W/O Property Tax Deduction	Full Reagan Proposal
Before-Tax Cost	$5,200	$6,200	$6,200	$6,200
Interest	$4,200	$5,200	$5,200	$5,200
Property Tax	$1,000	$1,000	$1,000	$1,000
Marginal Tax Rate	16%	16%	16%	15%
Tax Savings	$245	$405	$245	$180
After-Tax Cost	$4,955	$5,795	$5,955	$6,020
Change in Cost ($)	-----	$840	$1,000	$1,065
Change in Cost (%)	-----	17%	20%	21%

1/ Example assumes a joint tax return with four exemptions. Home is financed with 20 percent downpayment and a fixed rate, 30 year mortgage for the remaining 80 percent of the purchase price; MRB financing at 10.5%, conventional financing at 13%. Property taxes are 2 percent of the home value.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

- Second home mortgage interest deductions would be limited under the Reagan proposal by including second home interest with other personal interest and limiting the total to $5,000, plus passive investment income, after a phase-in. The rationale for this limitation is that a second home is "extraordinary consumption" enjoyed by a relatively few, high-income households which should not be subsidized by the government.

Analysis indicates that the loss of property tax deductibility and limitations on mortgage interest would cause the after-tax cost of the typical $60,000 second home to rise from 25 to 60 percent depending on the circumstances of the taxpayer who owns or is considering the purchase of a second home. This has the potential of reducing second home property values 20 to 40 percent and depressing the economies of many second or vacation home communities which exist in nearly every state. (See Appendix I)

It is also important to note that a Federal Reserve Board survey reveals that in 1983 over 60 percent of Americans who owned second homes had incomes of $30,000 or less. In fact, it is these low- and middle-income families who are second home owners who would be adversely impacted by this provision.

Table 8

Households Owning Seasonal Residences by Income: 1983 1/

Income Class ($ thousands)	Households Owning Seasonal Residence (# thousands)	Percent of Total Households	Percent of Seasonal Residences	Average Value of Seasonal Residence
0 - 10	581	1.7	26.6	$14,800
10 - 30	740	1.9	33.9	$10,600
30 - 50	351	2.3	16.1	$13,700
50 - 100	362	8.7	16.6	$43,300
Greater than 100	149	18.9	6.8	$94,900
Total	2,183	2.4	100.0	$58,600

1/ The definition of seasonal residence includes mobile homes and time sharing units.

SOURCE: 1983 Survey of Consumer Finances.

- Tax revision should not discourage investment in rental residential and commercial real estate. Rental residential and commercial real estate investments would become less attractive under the Reagan proposal due to a number of key provisions: reduced depreciation allowances, a change in capital gains treatment, limitations on interest deductions by certain types of investors, extension of the at risk rule to real estate, and numerous others. (See Appendix J) These changes would reduce the yield on a typical commercial structure from 17 percent to 60 percent (See Appendix K) while the yield on a new low-income rental residential property would fall 50 to 130 percent (actually turn negative in some cases). (See Appendix L) In the short-run these extreme declines in yield would result in abrupt declines in new investment and sharp declines in the value of existing properties. Over the long-run the decline in investment could produce rent increases for both renting household and business tenants ranging from 10 percent to 40 percent.

Table 9

Potential Impact of Reagan Proposal on Commercial and Rental Residential Real Estate Investments
(Percent Change from Current Law, Mortgage Rates Unchanged)

	Investment Yield	Long-Term Rents	Change in Value
Typical Commercial	-17% to -60%	+8% to +30%	-14% to -40%
Typical New Low-Income Rental Residential	-50% to -130%	+15% to +42%	-30% to -70%

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

1. Retroactive Depreciation Tax

The proposal would deny taxpayers who claimed "excess" depreciation writeoffs between 1980 to 1985 the "windfall" benefit attributable to the reduction in tax rates. Taxpayers with less than $400,000 of total depreciation deduction during 1980 to 1985 would be exempt from the rules. Forty percent of depreciation actually taken during 1980 to 1985 in excess of what could have been taken under 40 year straight-line depreciation would be automatically included in income between 1986 to 1988. The first $300,000 of this excess is further exempt. It is important to note that this provision is effective without any disposition of the asset so the taxpayer must pay the additional tax out-of-pocket or borrow.

For example, a $3 million property placed in service in 1981 and depreciated over 15 years using the straight-line method would have yielded $1 million in total depreciation expense between 1981-1985. Since this is in excess of the $400,000 threshold, the taxpayer must compute his excess depreciation. The $3 million property depreciated over the 40 year earnings and profit method would yield $375,000 of depreciation expense between 1981-1985. The excess depreciation ($1,000,000 - $375,000) equals $625,000. Subtract from this the $300,000 exemption, and you have a net excess of $325,000. Forty percent of this excess, $130,000, is included in income over 3 years 1986-88 at 12% in 1986, 12% in 1987 and 16% in 1988. This means $39,000 will be imputed to the taxpayers income each of the first 2 years for an increase in tax (assuming a 35% bracket taxpayer) of $13,650 for each year. In the third year $52,000 will be imputed to income for an increase tax of $18,200.

This shows that even a modestly priced real estate investment will cause significant tax increases to investors. This tax increase is exacerbated by the fact that the rule operates automatically, not when the asset is sold, forcing the taxpayer to pay the extra tax out-of-pocket.

2. Limitation on Interest Deductions by Individuals. The President proposes to limit the investment interest deduction to $5,000 plus passive investment income. This means that all deductible interest expense will be limited to: interest on a taxpayer's principal residence; $5,000 of interest on consumer (including interest expenses incurred to purchase a second home, car, education loans, etc.) and investment interest (investment interest under this $5,000 cap would include the interest expenses of Section 1231 "net-leased" property, as under current law, and is expanded to include interest expense passed through from limited partnership investments). This $5,000 cap is increased by any passive "investment income" received by the taxpayer -- such as interest, dividends, etc. Interest expense for properties owned by sole proprietors or general partnerships would generally not be subject to this limitation. This provision discriminates heavily in favor of wealthy taxpayers against middle class Americans who must borrow money to invest in real estate. This is because the proposals allow wealthy taxpayers who have other "investment income" (such as income from trusts, stock investments, etc.) to increase the proposed $5,000 interest cap. Only average wage earners who do not have the luxury of excess investment income will be severely impacted and discouraged from making a modest investment into a real estate limited partnership. This result could shift the ownership of real estate back, as it was several decades ago, into the hands of the wealthy and large corporations.

In our view, interest expenses paid by investors, limited partnerships or sub S corporations are real business costs to the taxpayer and are not "tax-sheltered paper losses". By disallowing the deduction for these real costs, the President's proposal has the effect of increasing the cost of investment, thus affecting capital formation by reducing the capital availability for new investment.

3. Change in Depreciation Schedule for Structures. Under the President's proposal a new depreciation system called the Capital Cost Recovery System (CCRS) would replace the current ACRS system. Cost recovery periods for structures would be increased from the current 18 years to 28 years with inflation indexing of the depreciation base. The first year's depreciation deduction would be 4 percent of the real property basis rather than the 5.5 percent (straight-line) or 10 percent (ACRS) of current law. At current inflation rates CCRS would provide only about 60 percent of the depreciation deductions provided by ACRS over a typical ten-year holding period. This is a significant increase in tax on depreciable capital and will act to discourage such investment in the future and thus lower the nation's capacity to grow.

Table 10

Depreciation Allowances for Structures Per $1,000 Investment 1/

	Current Law		CCRS (Reagan)		
	Cummulative Present Value				
Year	ACRS	St. Line	Cummulative Present Value	% Diff. From ACRS	% Diff. From St. Line
1	$50	$30	$20	-60.0%	-33.3%
2	130	83	56	-56.5	-32.1
3	192	130	89	-53.8	-31.6
4	248	172	118	-52.4	-31.3
5	291	208	144	-50.4	-30.8
6	323	241	169	-47.8	-30.0
7	352	270	192	-45.6	-29.0
8	373	295	213	-43.0	-28.0
9	392	318	232	-40.7	-26.9
10	409	338	251	-38.7	-25.8

1/ First year allowance assumes an asset is placed in service by a calendar year taxpayer on July 1, without regard to the mid-month convention. Cumulative present value calculation assumes a real interest rate of 8 percent and an inflation rate of 5 percent.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

4. Changed Capital Gains Treatment. For nondepreciable assets such as stocks and bonds, the Reagan proposal would reduce the current 60 percent exclusion to 50 percent. With lower marginaltax rates the effective capital gains tax rate for individuals would be reduced from 20 percent to 17.5 percent. Despite this lower effective tax rate, capital gains on this type of asset would be more heavily taxed relative to ordinary income under the Reagan proposal than under current law.

Depreciable assets such as structures would not be eligible for this 50 percent exclusion. However, when computing the capital gain on a depreciable asset the inflation-adjusted depreciation base rather than the original basis or cost would be used. The impact of this change is that if a property appreciates at roughly the overall rate of inflation, capital gains tax would probably be less than if it were computed with a 50 percent exclusion. However, if the property is a wise investment and appreciates 3 or more percentage points faster than the overall inflation rate, the tax would be more than if computed with a 50 percent exclusion. Consequently, average and above average real estate investments would be taxed at a rate greater than financial assets that appreciated at a similar rate. This discrimination against long-life assets is unwise and unjustified.

Table 11

Comparison of Indexing versus 50% Exclusion Capital Gains Treatment [1/]

Overall Inflation Rate	Property Appreciation Rate	Tax	
		Indexing	Exclusion
5%	0%	-22,011	0
5%	5%	0	11,006
5%	8.5%	22,100	22,100
5%	10%	33,770	27,890
5%	15%	84,583	53,297

[1/] Example based on a $100,000 property held for 10 years by a taxpayer in the 35% tax bracket. For simplicity the effects of depreciation, property taxes, selling expenses and the alternative minimum tax, if any, are ignored.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

5. At-Risk Rules Extended to Real Estate. The President proposes to extend at-risk limitations to real estate. Under current law, the loss a taxpayer may deduct from a non-real estate investment is limited to the amount the taxpayer has at-risk with respect to the investment. Essentially, this means investors can claim losses only up to the cash-plus mortgages for which the investor is personally liable.

The reason real estate has not been included is the fact that real estate is taxable and its value can be carefully appraised for both lender and borrower to understand the degree of risk. Further, because of this fact, and becauee of practical business considerations, the historical method of financing real estate, whether housing or commercial investment, has included non-recourse debt.

The underlying tax-treatment of an asset should not be altered by the type of financing used. Arbitrarily extending the at-risk rules to real estate slows down the tax writeoffs for assets that are debt-financed as opposed to equity-financed. This exacerbates the non-neutrality of the tax system and distorts the marketplace.

The Administration has opened the door in its proposal to an exemption from the at-risk rules for real estate financed through a third party lending institution, thus assuring arms-length arrangements. Such an exemption would effectively limit potential abusive transactions that involve seller financing where the basis is artificially inflated for capital gains and depreciation purposes. Non-abusive transactions could, therefore, be exempt from unnecessary and unwise extension of the at-risk rules.

6. Repeal of Tax-Exempt Status for Industrial Development Bonds. The President's plan proposes to repeal the tax-exempt status of industrial development bonds. Private purpose bonds, however, have had strict limits placed on them in 1980, 1982 and 1984. Further limits do not seem necessary or fair.

   IDBs play an important role in financing low income rental housing. IDB tax exempt status could be preserved for use for low income rental housing and during times of recessions or high interest periods.

7. Repeal of Qualified Rehabilitation Tax Credit. The President proposes to repeal the rehabilitation tax credit for qualified old or historic buildings. Depending on the age of the building, credits are available of 15 percent, 20 percent or 25 percent. The President claims no evidence exists to prove the credits are an appropriate incentive for rehabilitation for older buildings when compared to the incentives available to rehabilitators of newer buildings. However, the credits are useful to deteriorating areas in promoting stability and economic vitality. This is particularly important to cities in the Northeast and North Central. Also, initial tax revenue loss attributable to the tax credit is made up in some areas over two and one-half times within five years by increased revenue generated at state and local levels. This is the same revitalization effect that Enterprise Zones are predicted by the President to have on distressed areas.

8. Capitalization of Construction Period Interest. The President proposes to capitalize, as part of the cost of constructing a residential or commercial project any interest paid or incurred during the construction period. This proposal would require construction period interest to be included in the basis of the project and recovered by allowances for depreciation. Since the President's plan would lengthen the recovery period for depreciation of structures from 18 years (15 for low-income housing) to 28 years, the proposed treatment of construction period interest would mean that construction period interest, which under current law is amortized over ten years (and deducted currently for low-income housing), would be recovered over the lengthened cost recovery period for real estate. Moreover, the President's plan does not provide any special treatment for low-income housing. The proposal regarding construction period interest will increase the costs of rental housing and commercial real estate, cause increases in rents for both residential and commercial tenants, and contribute to higher rates of unemployment in the construction industry.

Appendix A

Macroeconomic Impacts of the Reagan Tax Reform Proposal
(% Change from Baseline Except where Otherwise Noted)

	1986	1987	1988	1989	1990	1995
Real GNP	- 0.2	- 1.0	- 1.0	- 1.3	- 1.3	- 0.5
Income Per Household (85 $'s)	-$50	-$200	-$320	-$510	-$730	-$900
Employment	0.0	- 0.5	- 0.6	- 0.5	- 0.5	- 0.1
Labor Productivity	- 0.2	- 0.5	- 0.6	- 1.0	- 1.2	- 1.8
Inflation (% point change)	0.0	- 0.1	- 0.2	- 0.3	- 0.4	- 0.2
Real Consumption	0.0	- 0.4	- 0.4	- 0.6	- 0.7	0.0
Real Fixed Investment	- 1.3	- 3.7	- 3.9	- 3.7	- 3.1	- 2.0
Residential	- 3.0	- 6.3	- 5.1	- 4.5	- 4.3	- 3.9
Nonresidential	- 0.8	- 3.0	- 3.5	- 3.5	- 2.8	- 1.4
Equipment	- 0.9	- 3.6	- 4.3	- 4.2	- 3.2	- 1.9
Structures	- 0.4	- 1.4	- 1.6	- 1.6	- 1.6	- 1.0
Housing Starts	- 7.0	- 8.6	- 5.9	- 5.4	- 5.3	- 4.1
Single Family	- 6.3	- 7.9	- 5.3	- 5.2	- 5.0	- 3.9
Multi-Family	- 8.5	- 9.9	- 7.0	- 5.9	- 6.0	- 4.6
Existing Home Sales	- 8.0	- 9.0	- 8.0	- 7.0	- 6.0	- 5.0
Value of the Stock of Single Family Homes	-10.0	-10.2	-10.7	-11.2	-11.5	-10.5
Effective Mortgage Rate (% point change)	0.22	0.35	0.37	0.41	0.45	0.77
Aaa Bond Rate (% point change)	0.20	0.29	0.31	0.36	0.39	0.72
3 Month T-Bill Rate (% point change)	0.17	0.25	0.27	0.28	0.33	0.66
Rental Cost of Capital						
Structures	2.7	2.5	2.5	2.4	2.1	2.0
Equipment	10.3	8.2	7.5	6.9	6.1	4.2
Federal Deficit	2.6	13.1	16.3	17.5	17.2	37.5
Dollars (billions)	5	24	28	31	30	73
Cumulative Dollars (billions)	5	29	57	88	118	390
Federal Revenues	- 0.6	- 2.5	- 2.8	- 3.0	- 2.9	- 5.2
Personal Tax	- 6.7	- 7.5	- 8.0	- 7.4	- 7.4	- 7.2
Corporate Tax	31.0	16.1	17.9	16.7	21.0	1.6

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix B

Comparison of Tax Provisions Impacting After-Tax Homeownership Costs Under Current Law and the Reagan Proposal

	1986 Current Law	Reagan Proposal
PERSONAL MARGINAL TAX RATES	14 rate brackets from 11 to 50%	3 rate brackets 15%, 25%, 35%
EXEMPTIONS		
Self, spouse	$1,080	$2,000
Dependents	$1,080	$2,000
Elderly	$1,080	Credit
Blind	$1,080	Credit
ZERO BRACKET AMOUNTS		
Single	$2,480	$2,900
Joint	$3,670	$4,000
Heads of Household	$2,480	$3,600
INDEXED RATE BRACKETS, EXEMPTIONS, AND ZBA	Yes	Yes
PERSONAL DEDUCTIONS		
Mortgage Interest		
Principle Residence	Yes	Yes
Secondary Residence	Yes	Treated as other personal interest.
Other personal interest	Yes Investment interest limited to $10,000 over investment income.	Limited to $5,000 plus passive investment income. (Expanded definition of interest subject to limit)
Real Property Taxes	Yes	No
State and Local Income Taxes	Yes	No
Medical Expenses	Yes, above 5% of AGI	Yes, above 5% of AGI
Charitable Contributions	Yes, for itemizers and nonitemizers.	Deductible for itemizes but not for nonitemizers.
Two-Earner Deduction	Yes, 10% of lower salary.	No

Appendix B
(continued)

	1986 Current Law	Reagan Proposal
FRINGE BENEFITS		
Health Insurance	Not taxed	First $120 of premiums per year for individual coverage $300 for family coverage taxed.
Group-term life insurance	Premiums for insurance over $50,000 taxed.	Premiums for insurance over $50,000 taxed.
Other	Not taxed	Not taxed
OTHER INDIVIDUAL ITEMS		
Rollover of Capital Gains on Principal Residence	Capital gain tax deferred if seller purchases another residence costing at least as much as the one sold within two years.	Yes
One-time Exclusion on Capital Gains on Principal Residence	One-time exclusion exclusion of gain up to $125,000 on sale of principal residence for taxpayers 55 or older.	Same as current law.
Income Averaging	Yes	No
MUNICIPAL BONDS		
Public purpose	Tax-exempt	Tax-exempt
Private purpose	Tax-exempt	Taxed

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix C

Determination of the Impact of the Loss of Property Tax Deductibility on the After-Tax Cost and Value of an $85,000 Owner-Occupied Home [1/]

Case I

	1986 Current Law	1986 Current Law Without Property Tax Deduction	Full Reagan Proposal	Loss of Property Tax Deductibility as a Percent of Total Impact
Before Tax Cost ($)	$10,540	$10,540	$10,540	
Tax Savings ($)	1,664	1,292	726	
After Tax Cost ($)	8,876	9,248	9,814	
Change in Cost ($)	--	372	938	40%
Change in Cost (%)	--	4.2%	10.6%	
Change in Value ($)	--	-3,791	-8,653	44%
Change in Value (%)	--	-4.5%	-10.2%	

Case II

	1986 Current Law	Reagan Proposal with Property Tax Deduction	Full Reagan Proposal	Loss of Property Tax Deductibility as a Percent of Total Impact
Before Tax Cost ($)	$10,540	$10,540	$10,540	
Tax Savings ($)	1,664	981	726	
After Tax Cost ($)	8,876	9,559	9,814	
Change in Cost ($)	--	683	938	27%
Change in Cost (%)	--	7.7%	10.6%	
Change in Value ($)	--	-6,480	-8,653	25%
Change in Value (%)	--	-7.6%	-10.2%	

[1/] All examples assume a 20 percent downpayment, a 30 year fixed rate mortgage with a 13 percent interest rate, and property taxes equal to 2 percent of the home value. Required income assumes 25 percent of income is devoted to principal and interest payments. All tax calculations assume a joint return with four exemptions.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

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Appendix D

Total Impact of Reagan Proposal on After-Tax Homeownership Costs and Home Value by State

State	Average Home Price (Dollars)	Average Property Tax Rate (Percent)	Average Increase In After-Tax Homeownership Cost (Percent-Dollars)		Average Decline in Home Value (Percent-Dollars)	
Alabama	$ 56,500	0.42%	2.8%	$ 200	-3.0%	-$1,700
Alaska	136,700	1.06	18.0	2,000	-16.5	-22,600
Arizona	85,000	0.71	9.0	700	-8.8	-7,500
Arkansas	57,800	1.29	4.1	300	-4.3	-2,500
California	121,700	1.05	11.6	1,200	-11.4	-13,800
Colorado	90,700	0.95	5.9	500	-6.3	-5,700
Connecticut	118,800	1.60	13.1	1,400	-12.6	-14,900
Delaware	79,600	0.76	8.7	700	-8.7	-6,900
District of Columbia	133,600	1.17	18.3	2,000	-16.7	-22,400
Florida	76,100	0.92	8.8	600	-8.7	-6,600
Georgia	83,700	1.16	9.7	800	-9.5	-8,000
Hawaii	158,300	0.60	17.3	2,100	-15.8	-25,100
Idaho	58,100	1.02	3.7	200	-4.0	-2,300
Illinois	95,800	1.72	7.8	700	-8.0	-7,700
Indiana	70,800	1.23	6.9	500	-7.0	-5,000
Iowa	68,800	1.67	7.5	500	-7.6	-5,200
Kansas	68,800	1.00	6.4	400	-6.6	-4,500
Kentucky	66,100	1.02	6.3	400	-6.5	-4,300
Louisiana	72,500	0.14	5.1	300	-5.3	-3,800
Maine	67,000	1.52	7.2	500	-7.3	-4,900
Maryland	94,200	1.38	7.0	600	-7.3	-6,900
Massachusetts	101,300	1.85	13.1	1,300	-12.8	-13,000
Michigan	79,900	2.68	12.0	1,000	-11.4	-9,100
Minnesota	81,300	0.85	9.0	700	-8.9	-7,200
Mississippi	61,400	0.82	3.5	200	-3.7	-2,300
Missouri	64,100	1.09	6.3	400	-6.5	-4,200
Montana	46,600	1.17	2.9	100	-3.2	-1,500
Nebraska	62,700	2.12	7.8	500	-7.9	-4,900
Nevada	93,800	0.68	5.2	400	-5.6	-5,200
New Hampshire	87,100	2.23	14.5	1,300	-13.4	-11,700
New Jersey	110,000	2.54	15.1	1,600	-14.3	-15,700
New Mexico	60,500	0.90	3.6	200	-3.8	-2,300
New York	95,300	2.66	9.8	1,000	-9.8	-9,400
North Carolina	65,800	0.96	6.2	400	-6.4	-4,200
North Dakota	70,800	1.26	7.0	500	-7.1	-5,000
Ohio	84,800	1.15	9.8	800	-9.5	-8,100
Oklahoma	73,800	0.89	8.6	600	-8.6	-6,300
Oregon	68,700	2.27	8.4	600	-8.3	-5,700
Pennsylvania	58,100	1.71	4.7	300	-4.9	-2,800
Rhode Island	86,600	2.01	14.0	1,200	-13.1	-11,300
South Carolina	78,100	0.85	8.8	700	-8.7	-6,800
South Dakota	56,200	1.75	4.7	300	-4.9	-2,800
Tennessee	71,900	1.17	6.9	500	-7.0	-5,000
Texas	85,300	1.36	10.2	900	-9.9	-8,400
Utah	85,800	0.97	9.5	800	-9.3	-8,000
Vermont	65,500	1.67	7.3	500	-7.4	-4,900
Virginia	91,900	1.28	6.7	600	-7.1	-6,500
Washington	80,900	1.03	9.3	700	-9.2	-7,400
West Virginia	54,400	0.68	3.1	200	-3.4	-1,800
Wisconsin	87,600	1.90	8.1	700	-8.4	-7,300
Wyoming	60,500	0.45	2.9	200	-3.2	-1,900

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix E

Impact of Loss of Property Tax Deductibility on After-Tax Homeownership Costs and on Home Values by State
(Case I: 1986 Current Law Without Property Tax Deduction)

State	Average Home Price (Dollars)	Average Property Tax Rate (Percent)	Average Increase In After-Tax Homeownership Cost (Percent-Dollars)		Average Decline in Home Value (Percent-Dollars)	
Alabama	$ 56,500	0.42%	0.8%	$40	-0.8%	-$480
Alaska	136,700	1.06	5.0	550	-5.4	-7,340
Arizona	85,000	0.71	1.9	150	-2.1	-1,770
Arkansas	57,800	1.29	2.2	130	-2.4	-1,370
California	121,700	1.05	4.0	420	-4.3	-5,260
Colorado	90,700	0.95	2.9	240	-3.2	-2,860
Connecticut	118,800	1.60	5.8	630	-6.2	-7,320
Delaware	79,600	0.76	2.0	150	-2.2	-1,770
District of Columbia	133,600	1.17	5.4	590	-5.8	-7,800
Florida	76,100	0.92	2.4	180	-2.6	-2,010
Georgia	83,700	1.16	3.0	240	-3.2	-2,710
Hawaii	158,300	0.60	3.0	360	-3.2	-5,120
Idaho	58,100	1.02	1.7	110	-1.9	-1,120
Illinois	95,800	1.72	4.9	460	-5.2	-5,010
Indiana	70,800	1.23	2.6	190	-2.9	-2,050
Iowa	68,800	1.67	3.5	250	-3.8	-2,580
Kansas	68,800	1.00	2.2	150	-2.4	-1,660
Kentucky	66,100	1.02	2.2	150	-2.5	-1,620
Louisiana	72,500	0.14	0.3	20	-0.4	-270
Maine	67,000	1.52	3.2	220	-3.5	-2,330
Maryland	94,200	1.38	4.0	360	-4.4	-4,100
Massachusetts	101,300	1.85	6.5	620	-6.9	-7,010
Michigan	79,900	2.68	6.1	540	-6.4	-5,110
Minnesota	81,300	0.85	2.2	170	-2.5	-2,000
Mississippi	61,400	0.82	1.4	90	-1.6	-970
Missouri	64,100	1.09	2.3	150	-2.6	-1.670
Montana	46,600	1.17	1.7	90	-1.9	-880
Nebraska	62,700	2.12	4.2	290	-4.6	-2,860
Nevada	93,800	0.68	2.1	180	-2.3	-2,190
New Hampshire	87,100	2.23	6.1	540	-6.4	-5,600
New Jersey	110,000	2.54	8.6	920	-8.8	-9,700
New Mexico	60,500	0.90	1.6	100	-1.7	-1,040
New York	95,300	2.66	7.1	710	-7.3	-7,000
North Carolina	65,800	0.96	2.1	140	-2.3	-1,530
North Dakota	70,800	1.26	2.7	200	-3.0	-2,090
Ohio	84,800	1.15	3.0	240	-3.2	-2,730
Oklahoma	73,800	0.89	2.3	160	-2.6	-1,890
Oregon	68,700	2.27	4.5	340	-4.8	-3,300
Pennsylvania	58,100	1.71	2.8	180	-3.0	-1,750
Rhode Island	86,600	2.01	5.6	490	-5.9	-5,130
South Carolina	78,100	0.85	2.2	170	-2.5	-1,920
South Dakota	56,200	1.75	2.8	180	-3.1	-1,720
Tennessee	71,900	1.17	2.5	190	-2.8	-1,990
Texas	85,300	1.36	3.4	290	-3.7	-3,170
Utah	85,800	0.97	2.5	210	-2.8	-2,370
Vermont	65,500	1.67	3.5	240	-3.8	-2,460
Virginia	91,900	1.28	3.8	330	-4.1	-3,760
Washington	80,900	1.03	2.7	210	-2.9	-2,360
West Virginia	54,400	0.68	1.2	70	-1.3	-720
Wisconsin	87,600	1.90	5.3	470	-5.7	-4,970
Wyoming	60,500	0.45	0.8	50	-0.9	-550

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix F

Impact of Loss of Property Tax Deductibility on After-Tax Homeownership Costs and on Home Values by State
(Case II: Reagan Proposal with Property Tax Deductibility)

State	Average Home Price (Dollars)	Average Property Tax Rate (Percent)	Average Increase In After-Tax Homeownership Cost (Percent-Dollars)		Average Decline in Home Value (Percent-Dollars	
Alabama	$ 56,500	0.42%	0.6%	$40	-0.7%	-$380
Alaska	136,700	1.06	3.3	360	-2.6	-3,520
Arizona	85,000	0.71	1.1	90	-1.0	-870
Arkansas	57,800	1.29	1.8	110	-1.9	-1,080
California	121,700	1.05	3.0	320	-2.7	-3,300
Colorado	90,700	0.95	2.6	220	-2.6	-2,370
Connecticut	118,800	1.60	4.4	480	-3.9	-4,620
Delaware	79,600	0.76	1.2	90	-1.1	-870
District of Columbia	133,600	1.17	3.6	390	-2.8	-3,750
Florida	76,100	0.92	1.4	110	-1.3	-1,000
Georgia	83,700	1.16	1.8	150	-1.6	-1,340
Hawaii	158,300	0.60	1.9	240	-1.5	-2,420
Idaho	58,100	1.02	1.5	90	-1.5	-880
Illinois	95,800	1.72	4.4	410	-4.4	-4,170
Indiana	70,800	1.23	1.8	130	-1.7	-1,230
Iowa	68,800	1.67	2.4	170	-2.3	-1,550
Kansas	68,800	1.00	1.5	100	-1.4	-990
Kentucky	66,100	1.02	1.5	100	-1.5	-970
Louisiana	72,500	0.14	0.2	20	-0.2	-160
Maine	67,000	1.52	2.2	150	-2.1	-1,400
Maryland	94,200	1.38	3.6	320	-3.6	-3,410
Massachusetts	101,300	1.85	4.9	470	-4.4	-4,450
Michigan	79,900	2.68	3.7	320	-3.2	-2,560
Minnesota	81,300	0.85	1.3	100	-1.2	-990
Mississippi	61,400	0.82	1.2	80	-1.2	-760
Missouri	64,100	1.09	1.6	100	-1.6	-1,000
Montana	46,600	1.17	1.6	80	-1.7	-800
Nebraska	62,700	2.12	2.9	200	-2.8	-1,730
Nevada	93,800	0.68	1.9	160	-1.9	-1,810
New Hampshire	87,100	2.23	3.3	290	-2.7	-2,350
New Jersey	110,000	2.54	6.5	700	-5.6	-6,170
New Mexico	60,500	0.90	1.3	80	-1.4	-820
New York	95,300	2.66	6.3	630	-6.1	-5,840
North Carolina	65,800	0.96	1.4	90	-1.4	-920
North Dakota	70,800	1.26	1.8	130	-1.8	-1,250
Ohio	84,800	1.15	1.8	150	-1.6	-1,350
Oklahoma	73,800	0.89	1.4	100	-1.3	-940
Oregon	68,700	2.27	3.1	230	-2.9	-1,990
Pennsylvania	58,100	1.71	2.3	150	-2.4	-1,380
Rhode Island	86,600	2.01	3.0	260	-2.5	-2,150
South Carolina	78,100	0.85	1.3	100	-1.2	-950
South Dakota	56,200	1.75	2.4	150	-2.4	-1,360
Tennessee	71,900	1.17	1.7	130	-1.7	-1,190
Texas	85,300	1.36	2.1	170	-1.8	-1,570
Utah	85,800	0.97	1.5	120	-1.4	-1,170
Vermont	65,500	1.67	2.4	160	-2.3	-1,480
Virginia	91,900	1.28	3.4	290	-3.4	-3,120
Washington	80,900	1.03	1.6	120	-1.4	-1,170
West Virginia	54,400	0.68	1.0	60	-1.0	-570
Wisconsin	87,600	1.90	4.7	420	-4.7	-4,130
Wyoming	60,500	0.45	0.7	40	-0.7	-430

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix G

Demographic Characteristics of Taxpayers who Claim the Real Estate Tax Deduction

	Percent of Returns within Each Category		Returns as Percent of Total	
	Itemizers Claiming Real Estate Deductions	Other Taxpayers	Itemizers Claiming Real Estate Deductions	Other Taxpayers
I. MARITAL STATUS				
Single Returns	13.4	54.1	8.4	91.6
Joint and Other Returns	86.6	45.9	41.3	58.7
Total	100.0	100.0	27.1	72.9
II. FAMILY STATUS				
Returns with no dependents	38.5	70.7	16.8	83.2
Returns with Dependents	61.5	29.3	43.8	56.2
Total	100.0	100.0	27.1	72.9
Addendum:				
Returns with 2 or more dependents	40.9	16.4	48.1	51.9
Returns with 3 or more dependents	17.1	7.4	46.2	53.8
III. AGE OF HOUSEHOLD HEAD				
Less than 20	0.1	12.6	0.3	99.7
20 to 24	2.5	18.4	4.8	95.2
25 to 29	10.8	14.1	22.2	77.8
30 to 34	14.6	10.1	35.1	64.9
35 to 39	15.3	7.6	42.7	57.3
40 to 44	13.1	5.9	45.4	54.6
45 to 49	10.5	4.7	45.2	54.8
50 to 59	18.7	9.4	42.4	57.6
60 to 69	7.4	6.6	29.6	70.4
70 and Above	7.0	10.7	19.7	80.3
Total	100.0	100.0	27.1	72.9

Explanatory Note: While only 27.1 percent of tax returns claim real estate property taxes as an itemized deduction, 86.6 percent of those who do are joint or other family type returns. Nearly 2 of every 3 (61.5%) property tax itemizers have dependents. Thus, repeal of property tax deductibility can be viewed as anti-family.

SOURCE: 1982 Statistics of Income - Individual Income Tax Returns.

Appendix H

Impact of the Reagan Proposal on Homebuyers and Renters 1/

	Family Income					
	$21,500		$36,000		$64,000	
	Homebuyer	Renter	Homebuyer	Renter	Homebuyer	Renter
One-Earner Family of Four 2/						
Federal Tax						
Current Law	$ 957	$1,865	$ 2,418	$4,803	$ 6,346	$12,674
Reagan Proposal	981	1,451	2,572	3,629	6,629	10,529
Change: $	+24	-414	+154	-1,174	+283	-2,145
Change: %	+2.5%	-22.2%	+6.4%	-24.4%	+4.5%	-16.9%
Two-Earner Family of Four 3/						
Federal Tax						
Current Law	$ 622	$1,522	$ 2,026	$4,369	$ 5,729	$11,952
Reagan Proposal	809	1,451	2,358	3,629	6,228	10,128
Change: $	+187	-71	+332	-740	+499	-1,824
Change: %	+23.1%	-4.8%	+14.7%	-20.4%	+8.0%	-18.19%

1/ Mortgage interest and property tax deductions for families with incomes of $21,500, $36,000, and $64,000 are based on homes costing $50,000, $85,000 and $150,000, respectively. The mortgage interest deduction is the first year interest on an 80 percent loan-to-value ratio loan with an interest rate of 13 percent. The property tax deduction is 2 percent of property value. All non-homeownership deductions are the average for joint returns with itemized deductions, according to the 1982 Statistics of Income - Individual Income Tax Returns. Renters are assumed to have the same level of these deductions as homebuyers.

2/ Child-care credit not used.

3/ Income of family is split two-thirds, one-third between the two earners. Two-earner deduction and child-care credit are used.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Impact of the Reagan Proposal on a Typical Second Home 1/

	1986 Current Law	Reagan Proposal		
		Case I	Case II	Case III
Before-Tax Cost	$7,440	$7,440	$7,440	$7,440
Marginal Tax Rate	38%	25%	25%	25%
Total Allowed Deductions	$7,440	$6,240	$2,500	0
Tax Savings	$2,827	$1,560	$ 625	0
After-Tax Cost	$4,613	$5,880	$6,815	$7,440
Change in Cost ($)	——	$1,267	$2,202	$2,827
Change in Cost (%)	——	28%	48%	61%
Change in Home Value (%)	——	-22%	-30%	-38%

Case I: All mortgage interest is deductible since dividend and interest income raises the limit on interest deductions so that it is not binding on the taxpayer.

Case II: Only $2,500 of mortgage interest is deductible due to the $5,000 limit on other personal interest deductions. Taxpayer has $2,500 of non-mortgage interest deductions.

Case III: No mortgage interest is deductible due to the $5,000 limit on other personal interest deductions. Taxpayer already has $5,000 of non-mortgage personal interest deductions.

1/ This table assumes a $60,000 second home purchased with a $12,000 downpayment and a $48,000 mortgage at 13 percent resulting in about $6,240 of mortgage interest the first year. Property taxes are assumed to be 2 percent of the property value or $1,200. The buyer is assumed to have a $70,000 adjusted gross income, to file a joint return with 4 exemptions, and to have other itemized deductions totaling $13,000, the average for itemizing taxpayers at this income level.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix J

Comparison of Tax Provisions Impacting Commercial Real Estate Under Current Law and the Reagan Proposal

	1986 Current Law	Reagan Proposal	
Personal Marginal Tax Rates	14 rate brackets from 11% to 50%	3 rate brackets 15%, 25%, 35%	
Personal Deductions			
Personal Interest other than mortgage interest on principal residence.	Yes Investment interest limited to $10,000 over investment income.	Limited to $5,000, plus passive investment income. Expanded definition of interest subject to limit. Includes secondary residence and limited partners share of the interest expense of the partnership.	
Corporate Tax Rates	15 to 40 percent on first $100,000, 46 percent above $100,000.	15 to 25 percent on first $75,000, 33 percent above $75,000.	
Depreciation	18 year life; 175% declining balance.	4% of inflation-adjusted basis. 28 year closeout.	
Capital Gains			
		Depreciable Assets	Nondepreciable Assets
Exclusion	60%	0	50%
Basis indexed for inflation	No	Yes	No
Construction Period Interest And Taxes	10 year amortization allowed.	Repealed. Added to real property basis.	
Interest Expense	Fully deductible for property used in trade or business.	Same as current law.	

Appendix J
(continued)

	1986 Current Law	Reagan Proposal
Investment Tax Credit	6% - 10%	Repealed
Rehabilitation Tax Credits	15% credit for 30 year old nonresidential structures; 20% credit for 40 year old nonresidential structures; 25% credit for historic residential and nonresidential structures.	Repealed
Section 167K Rules	Rehabilitation expenses for low income housing can be depreciated over 60 months.	Repealed
Installment Sales	Taxation deferred until payment received.	No deferral if receivables pledged as collateral.
"At Risk" Rules	Real estate exempt. Deductions may exceed the amount of equity plus recourse financing.	"At risk" rule extended to real estate. Cumulative losses limited to equity plus recourse financing.
Partnerships	"Pass-thru" of gains and losses to individual partners.	Same as current law.
Mortgage Revenue Bonds	Interest is Tax Exempt	Interest Taxed
Industrial Development Bonds	Interest is Tax Exempt	Interest Taxed

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix K

Impact of Reagan Proposal on a Typical Commercial Real Estate Investment 1/ (Percent Change from Current Law, Mortgage Rates Unchanged)

Description	1st Year Taxable Income	1st Year After-Tax Cash Flow	10-Year IRR 2/	10-Year NPV 3/	Long-Term Rents 4/	Change in Value 5/
Reagan Proposal						
Case A	+ 45%	- 67%	-17%	- 27%	8%	-14%
Case B	+ 94%	-104%	-26%	- 48%	10%	-16%
Case C	+171%	-162%	-61%	-144%	31%	-38%

Case A: Property owned by sole proprietor or general partners.

Case B: Limited partners having full use of the cap on other personal interest of $5,000 plus net investment income, here interpreted as their pro-rata share of net operating income less depreciation.

Case C: Limited partners who have exhausted their ability to deduct other personal interest so no interest can be deducted.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

Appendix E
(continued)

1/ Assumptions underlying typical commercial real estate investment.

Basis: $1,000,000 project acquired 1/1/86 with original basis allocated $150,000 to land, $50,000 to furniture, fixtures & equipment, and $800,000 to real property.

Financing: $250,000 initial equity and 30-year conventional mortgage for $750,000 at 13.5% interest.

Income and Expenses: Net operating income of $100,000 increasing at 5% per year.

Current Law Depreciation: 18 years ACRS for real property, 5 years ACRS for personal property.

Projected Value: Starting value of $1,000,000 increasing at 5% per year.

Expenses of Sale: Selling expenses of 6% upon ultimate sale.

Ownership: Individual taxpayer(s) in a marginal tax bracket of 50% under current law.

2/ Internal Rate of Return: the discount rate at which the present value of all future after-tax benefits equals the initial capital contribution.

3/ Net Present Value: The sum of all future after-tax benefits less initial capital contribution, discounted to 1/1/86 at 11% per annum.

4/ Long-Term Rent: The percentage amount that rents would have to change for 10-year IRR to be restored to the level under current law, all else being equal.

5/ Change in Value: The percentage change in the value of the property that would likely occur in the short-run prior to changes in rents.

Note: For purposes of indexing capital assets, adjusted basis, and interest indebtedness a 5 percent inflation rate was assumed.

Appendix L

Impact of Reagan Proposal on a Typical New Low-Income Housing Investment [1/]
(Percent Change from Current Law,
Mortgage Rates Unchanged)

Description	1st Year Taxable Income	1st Year After-Tax Cash Flow	10-Year IRR [2/]	10-Year NPV [3/]	Long-Term Rents [4/]	Change in Value [5/]
Reagan Proposal						
Case A	+ 82%	- 76%	- 50%	- 98%	15.3%	-30%
Case B	+ 97%	- 85%	- 68%	-167%	15.3%	-40%
Case C	+144%	-114%	-129%	-405%	41.9%	-70%

Case A: Property owned by sole proprietor or general partners.

Case B: Limited partners having full use of the cap on other personal interest of $5,000 plus net investment income, here interpreted as their pro-rata share of net operating income less depreciation.

Case C: Limited partners who have exhausted their ability to deduct other personal interest so no interest can be deducted.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

1/ Assumptions underlying typical new low-income housing investment.

Basis: $1,000,000 project placed in service 1/1/86 with original basis allocated $150,000 to land, $50,000 to furniture, fixtures & equipment, $725,000 to real property, and $75,000 to construction period interest and taxes (CPIT) which is expensed under current law.

Financing: $200,000 initial equity and 40-year mortgage for $800,000 at 12.75% interest, insured or guaranteed by a federal, state, or local government agency.

Income and Expenses: Regular tenant rent roll of $200,000 plus a rent subsidy of $15,000 per year, and operating expenses of $100,000 increasing at 5% per year. The rental income is increased in time only dollar for dollar with increasing expenses, for a constant 6.2% cash-on-cash return.

Current Law Depreciation: 15 years, 200% declining balance for real property, 5 years ACRS for personal property.

Projected Value: Starting value of $1,000,000 is presumed to remain constant due to a constant net operating income.

Expenses of Sale: Selling expenses of 6% upon ultimate sale.

Ownership: Individual taxpayer(s) in a marginal tax bracket of 50% under current law.

2/ Internal Rate of Return: the discount rate at which the present value of all future after-tax benefits equal the initial capital contribution.

3/ Net Present Value: The sum of all future after-tax benefits less initial capital contribution, discounted to 1/1/86 at 11% per annum.

4/ Long-Term Rent: The percentage amount that rents would have to change for 10-year IRR to be restored to the level under current law, all else being equal.

5/ Change in Value: The percentage change in the value of the property that would likely occur in the short-run prior to changes in rents.

Note: For purposes of indexing capital assets, adjusted basis, and interest indebtedness a 5 percent inflation rate was assumed.

Appendix M

Depreciation Allowances for Structures Per $1,000 Investment 1/

Years	Current Law Cummulative Present Value ACRS	 St. Line	CCRS (Reagan) Cummulative Present Value	 % Diff. From ACRS	 % Diff. From St. Line
1	$50	$30	$20	-60.0%	-33.3%
2	130	83	56	-56.5	-32.1
3	192	130	89	-53.8	-31.6
4	248	172	118	-52.4	-31.3
5	291	208	144	-50.4	-30.8
6	323	241	169	-47.8	-30.0
7	352	270	192	-45.6	-29.0
8	373	295	213	-43.0	-28.0
9	392	318	232	-40.7	-26.9
10	409	338	251	-38.7	-25.8
11	423	353	268	-36.8	-24.1
12	437	366	283	-35.1	-22.5
13	446	377	298	-33.1	-21.0
14	454	387	312	-31.3	-19.5
15	461	396	324	-29.7	-18.2
16	468	404	336	-28.1	-16.9
17	473	412	347	-26.6	-15.7
18	478	418	357	-25.3	-14 5
19	480	421	367	-23.7	-12.9
20	na	na	375	na	na
21	na	na	384	na	na
22	na	na	391	na	na
23	na	na	398	na	na
24	na	na	405	na	na
25	na	na	411	na	na
26	na	na	416	na	na
27	na	na	422	na	na
28	na	na	427	na	na
29	na	na	429	na	na

1/ First year allowance assumes an asset is placed in service by a calendar year taxpayer on July 1, without regard to themid-month convention. Cumulative present value calculation assumes a real interest rate of 8 percent and an inflation rate of 5 percent.

na/ Not applicable.

SOURCE: NATIONAL ASSOCIATION OF REALTORS®.

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STATEMENT OF SHELDON S. COHEN, FORMER COMMISSIONER OF INTERNAL REVENUE, AND SENIOR PARTNER, MORGAN, LEWIS & BOCKIUS, WASHINGTON, DC

Mr. COHEN. Thank you, Mr. Chairman. It is a pleasure to be before the committee today. I ought to say that the views I express today are my own personal view and not those of a client or of anyone in my firm. As you can see from the earlier testimony today, tax reform means many different things to different people. What we have it is an Internal Revenue Code that has become a hodgepodge of what were good ideas at the time. When amalgated, this has created a mess. It is a mess to administer from the Internal Revenue Service's or Treasury's point of view, and it is very difficult for the private citizen, and from industry's point of view.

One of the first things I want to say is that any time you deal with a minimum tax, you have admitted defeat. And the difficulty that we face here in looking at both Treasury I and the President's proposals is that we are admitting defeat. That is, we have come along with a minimum tax, which in effect is a patch which says that we designed a system that doesn't work well in many instances. So, we will have a patch to try to make it at least cosmetically work. I think we could do better than that. It is not simple. It is never going to be simple.

The economy we live in, particularly in the real estate area, is a very complex and widespread economy. Therefore, for the Tax Code to work, it is going to have to mirror the economy and will be somewhat complex. And indeed, the President's proposals that take over 400 pages to describe are not simple.

In the area of tax shelters, we are dealing with something that I guess as a draftsman for the Treasury in the early 1950's, I started. I was the draftsman of the first accelerated depreciation provision in 1954. And I should tell the committee that, at a drafting session across the street over in the Cannon Building at about 2 a.m. in the morning, I raised the question of a creeping basis or at risk. The Tax Legislative Counsel, at the time, wanted to shoot my head off, not because he didn't agree with me but because it was 2 a.m. in the morning and we had to report a draft to the committee the next morning at 10 a.m. So, the basic issue was conceived of at that time by the five or six of us in that drafting group. We recognized the problem. We saw it coming. Here we are some 31 years later still dealing with it.

I have dealt with the tax law now for 33 years, both as a lawyer and as an administrator. I think that tax shelters are a poor way to encourage either economic or social objectives. We are encouraging tax lawyers. I don't mind that. My children enjoy the good things of life. Accountants, promoters, and tax shelter sellers, all are enjoying the good life. However, we are not being very efficient in our use of our resources. And I should say, as an amateur economist, that none of this has anything to do with the creation of capital. You gentlemen have heard that term used often. We are talking about nothing today but skewing the use of capital. The question is: Ought we let the economic forces of this country determine as best they will, and they do it pretty efficiently, where capital should flow? Or are we going to do it in the tax laws? Now, that is not to say that we can walk away from every decision of that kind or should we. And indeed you will see in my testimony that I come out very strongly for some kind of a historic rehab, either credit or subsidy. That is an economic and a social judgment that each of us has to make, and it gets balanced out.

The difficulty is that we tend to put these things in the Internal Revenue Code, and we pretend, therefore that it doesn't cost anything to administer them, but it does. There is an Internal Revenue Service that is falling apart. The audit level is now 1.2 percent. There is chaos in that. People are losing confidence in their tax system; and if constantly pile—whether it is real estate or any other kind of benefits—through the Internal Revenue System, the system is going to break down. Indeed, a Governor of a State once came to me when I was Commissioner of Internal Revenue and said: Stop me from authorizing these private use bonds. He said: Politically, I must sign this bill, but all I am doing is providing a subsidy with no benefit to my State and an open call on the Treasury. He recognized what he was doing because he recognized that he wasn't providing any benefit that any other State didn't provide. They were just competing with one another. And all it was was an open call on the Treasury, with no particular benefit to any one particular State.

So, I would say to you that any program that you can design through the tax system, you can design equally efficiently at an equal cost of administration through a direct program. The difficulty is that the Congress has traditionally imposed higher administrative standards on a spending program than it does on a tax program. There is no reason for that.

[The prepared written statement of Mr. Cohen follows:]

Testimony Of

SHELDON S. COHEN

Before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

Concerning

THE PRESIDENT'S TAX PROPOSALS

On

July 16, 1985

Sheldon S. Cohen
Morgan, Lewis & Bockius
1800 M Street, N. W.
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Statement of Sheldon S. Cohen

Mr. Chairmen and Members of the Committee:

My name is Sheldon S. Cohen. I am in private tax practice in Washington, D. C. You will recall that I served as chief counsel of the Internal Revenue Service during 1964 and as Commissioner from January, 1965 through January, 1969. Thank you for inviting me to testify on the President's Tax Proposals, particularly as they relate to real estate, housing, and historic rehabilitation. The views I express today are solely my own and are not on behalf of my law firm or any of its clients.

I. The Proposals In General.

I will first discuss the Proposals in general, and then focus on the provisions that affect real estate and housing. I will conclude with a few words on tax administration.

Tax Reform is on everyone's lips these days. I believe everyone is in agreement that our tax code should be modernized and simplified. Unfortunately, everyone does not agree on the ingredients of reform.

The tax code is not a disgrace. What it is is a hodgepodge of ideas--each one having some reason (to help this group or solve that problem)--but on the whole, it is complex and often contradictory. The Code often has been used when direct appropriation or direct legislation would do just as well. We must stop using the tax law as an alternative to other types of legislation.

President Reagan to his credit has seized the issue and his proposals move in the right direction. The system should be fairer and more economically neutral, although you cannot enact a tax law which does not affect people's behavior -- so neutrality is only relative. I generally support the President's Proposals, although I prefer much of the first Treasury study of November, 1984. Indeed, Congressman Gephardt and Senator Bradley have proposed tax simplification and reform for several years. Their package would have different distributional effects but would be revenue neutral. Their plan would be an excellent starting point for this Committee.

I believe we all favor a progressive tax. The populists who pushed for an income tax in the 1880's and 1890's favored a progressive income tax also. Even the three rate structure proposed is mildly progressive. Rate structure, however, has little to do with simplification.

Deductions and credits are what creates complexity. If we can eliminate most or at least many of the deductions and credits, we can simplify tax return preparation and, just as importantly, increase the perception of fairness and simplicity.

The tax relief granted in the President's program is skewed. I am pleased to note that many members of this Committee have raised this issue also. My concern is that any program which grants its highest percentage of relief to the upper two or three percent of the income earners of the country and grants very little if any relief to our children cannot be all good. I have a married daughter. She and her husband have a small child in a child-care arrangement. They both have reasonably good salaries. They live in a condo and will lose the state and local tax deduction, and the marriage penalty deduction. When the smoke all clears, they get no real tax reduction. On the other hand, someone in my bracket gets a 30% reduction in rates and loses only state and local tax deduction. My net reduction in taxes is about 20%. On other occasions I have told this Committee that the Sheldon Cohens of America do not need tax relief. We need relief in the lower and middle income levels.

It is hard for me to understand why we are reducing taxes right now in any event. We are now experiencing tremendous deficits generated by the 1981 tax bill. The President's proposals are supposed to be revenue neutral--but they do not appear that way to me. By the Treasury's estimate, the proposals, if enacted in their present form, would cost $11.5 billion by fiscal year 1990. One of the major revenue raisers is what I will call the "Windfall Without Profits Tax", designed to recoup some of the ACRS benefits. This item alone would raise $56.5 billion in a three-year period, but nothing thereafter. I am not certain how many other provisions will cost extra revenues over time. Many of your Members have experienced similar concerns.

It would appear to me that the transition rules spelled out in the current proposals are not adequate. In the fall, the Secretary of the Treasury announced a very liberal attitude toward transition rules. Now, probably because of revenue considerations, much more stringent transition rules are suggested. I expect that they will be changed. Indeed, the study suggests now that transition rules are up to Congress. For example, the President's proposals suggest elimination of the historic building rehabilitation credit. Personally, I oppose that move, unless the credit is replaced by a direct federal expenditure, as I feel that we must have a differential in our system to preserve our historical heritage. But, even if you would repeal the credit, the President's proposals suggest repeal for expenditures made after December 31, 1985. The Treasury study, on the other hand, would have repealed it on the same date, except for binding contracts which existed before that time. Clearly, the President's proposal is unfair--both in its treatment of historical buildings and also because we all know that a binding contract rule is generally used when changes of this kind occur. It is only fundamental fairness, since the parties have committed and based their financing on the law as it stood at the time of the commitment. Thus, more realistic transition rules in this area as well as others will cost a great deal and should be accounted for in the revenue estimates.

I generally support the President's proposals to broaden the tax base by eliminating or cutting back on various deductions and credits. I am not sure he has gone far enough. The area of fringe benefits is of concern to me. Some people have them and others do not. These two groups of taxpayers are treated differently by the tax law. Does it really make a difference whether I pay for my life insurance or my health insurance or whether my employer does? I think not, and yet the tax law treats these situations quite differently. I could go down a whole list of exclusions from income which are available even under the President's program.

It will be tough for this Congress and later ones to hold the line against worthy deductions creeping back into the Code. You must set a standard to resist such temptation. Similarly situated taxpayers should pay the same tax. You should always remember that simplification does provide a benefit to our citizens and the IRS.

The acknowledgment in the current proposals that a minimum tax is needed is an acknowledgement of partial defeat. It means that the political compromise which has been introduced by the President has not addressed the problems directly. In order to ensure that all taxpayers pay some tax, he chose instead to deal with them indirectly through a minimum tax.

The Administration proposals at times are contradictory. For example, the proposals encourage equity capitalization and dividend distribution--at least they say they do. On the other hand, a taxpayer gets a full deduction for interest borrowed to purchase assets for his business. He can index the asset so that its value for tax depreciation purposes grows with inflation. Therefore, he will probably borrow the maximum possible because it is generally a good business decision. Likewise, the proposals say they encourage dividends through a partial dividends paid deduction. On the other hand, the proposals continue to favor capital gains by a special tax deduction. This means that if I don't take dividends, I can allow them to accumulate in the corporation. That should cause a rise in the value of my stock, which I can later sell for a low capital gains tax. These policy decisions are contradictory. The repeal of capital gains would do the most to remove complication from the tax code.

Another interesting thing happened in the capital gains area. The President's proposals have an election. I can either index the basis of my asset or exclude 50% of the gain from tax. This is not a simplification measure. Any time we have an election, taxpayers must maintain the records, and make both calculations. A taxpayer does not know which way will be the most beneficial to him until he makes the calculations.

The tax law which would result from the President's proposals would not be simple. After all, it took 400+ pages to describe it in only general terms. When it is described in technical language, I suspect it will be almost as thick as today's Code. That is not a reason not to try--it is merely a statement of fact. The President seems to feel his proposals will make this a very simple world--they will not.

II. Real Estate.

In general, I support those provisions of the President's proposals that relate to real estate and housing. However, I urge Congress to recognize that some of the Proposals would repeal tax subsidies consciously designed to promote social objectives. As a result, if Congress adopts the Proposals, it should consider whether to replace these tax subsidies with direct government expenditures. In particular, if the tax credits for historic rehabilitation are repealed, I believe that you should replace the particular credit with a direct spending program.

Tax Shelters.

The President's proposals withdraw most of the current provisions that have attracted unusual amounts of investment capital to the real estate and housing industries through tax shelters. These current provisions include ACRS (including the more liberal ACRS rules for low-income housing), the exclusion of real estate from the at-risk rules, the exclusion of interest paid or accrued by a limited partnership from the limited partner's investment interest limitation, the liberal treatment of construction period interest and taxes, the allowance of rapid amortization of expenses to rehabilitate low-income housing, and the favorable rules governing section 1231 assets. Other provisions of the President's proposals change the current practices that favor real estate developers, such as the pledge of mortgages as collateral for bonds, and the current deductibility of certain costs under the completed contract method of accounting. Other provisions would repeal the tax exemption for state or local bonds used to finance certain types of housing.

My thirty-three years as a tax lawyer and administrator have persuaded me that encouraging tax shelters is a poor way to promote a social objective, no matter how worthwhile that objective. Most often, the cost is high for the result achieved, and the cost is completely hidden. Tax revenues forgone as a result of tax shelters amount to off-budget expenditures. The amounts of lost revenue cannot be controlled. They become, in a sense, "entitlements" and operate in much the same manner. Thus, these programs never have to compete against the amounts spent for defense, social security cost of living adjustments, and other tough budgetary decisions. Also, we have created a favored class in the real estate business who either pay no tax or pay at rates similar to the low income groups rather than their own group -- the very wealthy. The progressive tax does not exist for these people.

In addition, the use of the tax shelters to promote real estate is unduly costly. Most of the benefits generated by tax shelters go not to reduce the cost of housing but rather to the upper income investors and the attorneys, accountants, and other intermediaries whose services help create the tax shelters.

Moreover, tax shelters create a significant administrative burden on the IRS. The IRS is the federal agency charged with administering the real estate and housing programs implicit in shelters. This is wrong. We have a Cabinet Department called HUD which is supposed to set and administer our housing and real estate programs. The burdens on the IRS are growing more significant each year, and the IRS' resources have diminished relative to its tax administration responsibilities. The fact is that the IRS has less personnel now than at the start of the Reagan administration, although the job is bigger and more complex.

Finally, tax shelters render the tax system complex, and they give an appearance of unfairness. This is one of the prime objectives of the current Proposals -- to eliminate the appearance of unfairness.

Direct Spending.

Although I generally support cutting back on current provisions that give rise to tax shelters, Congress should recognize that some of these provisions provide a conscious subsidy to certain parts of the real estate and housing industry. You may consider that continued subsidy for low-income rental housing are necessary. If so, it can be easily handled as a direct subsidy program.

The President's Proposals suggest elimination of the historic building rehabilitation credit. I do not favor this proposal, unless the credit is replaced by a direct subsidy. I believe we must have some differential in our system in order to encourage the preservation of our historical heritage. It is more costly to rehabilitate old historic buildings -- particularly when the strict rules of the Interior Department regarding rehabilitation are followed. We should keep the rehabilitation credit or provide a direct program for this vital need to preserve the American heritage.

These subsidies may take the form of federal programs that provide direct grants, or loans favored by federal guarantees, subsidized interest, or other favorable terms. There is much precedent for these types of programs.

Some will say that direct spending programs are too costly because they require a large bureaucracy. I disagree. Tax shelters are enormously costly, as discussed earlier. Moreover, the size of the bureaucracy for direct spending programs is largely at Congress' discretion. You have chosen to not administer many programs by putting them in the Internal Revenue Code, and then understaffing the IRS. The only real difference between federal expenditures made through the tax system and those made directly through government programs appears to be the level of review conducted by the administering agency. Benefits accorded through encouraging tax shelters are provided automatically, and any requirements are primarily enforced only through IRS audits, which rely on a very limited sampling. A direct expenditure program could be designed in exactly the same manner, that is, to automatically provide the subsidy upon request, as was the case with certain low interest student loans up until a few years ago. Of course, if Congress wishes to limit the amount of the subsidy, it would be necessary to provide a greater level of administrative review, which would necessitate greater administrative costs.

There are several other implications to the proposition that some of the provisions of current law that the President's Tax Proposals would eliminate provide subsidies that should be continued in some other form. First, the revenue estimates of amounts saved by the President's Tax Proposals may be optimistic, because some of the saved revenue should be expended through other means. Secondly, as a matter of procedure, Congress should not repeal certain provisions, such as the tax credits for historic rehabilitation, until the substitute direct-expenditure program is in place.

At Risk.

The proposals to extend the at-risk rules to real estate merit additional comment. The at-risk rules have two purposes. The first is to assure that if the value of the acquired property falls, the investor cannot walk away from his investment with tax losses that exceed his economic losses. The second purpose is to prevent investors from artificially inflating the value of their acquired investment for depreciation purposes.

The first purpose could be met by some means other than the at-risk rule, such as by requiring recapture of the claimed tax benefits, with interest or penalty charges. Similarly, it may be possible to achieve the second goal by limiting the application of the at-risk rules to purchase money mortgages in which abuse potential arises, and not to other situations (particularly, loans from an independent lender).

However, each of these alternatives to the at-risk rules could be difficult to administer. In addition, neither alternative by itself solves both problems. As a result, I believe it appropriate for you to extend the at-risk rules to real estate.

III. Tax Administration.

The return-free system suggested in the President's Tax Proposals is an interesting idea. I suspect it may be technically feasible in a few years. However, I would not want a repeat of this year's Philadelphia computer problem. Therefore, I would move very slowly on this concept. Also, I would suggest that a survey or sample of taxpayers be conducted before any such idea is implemented. The Service will now do computations and billings on a 1040A or 1040EZ. The overwhelming number of taxpayers make their own calculations anyway. They do it for two reasons: (1) they don't trust the IRS and (2) they want to know whether they owe money or are owed a refund. Therefore, only a small number of taxpayers accept the offer to compute taxes. To establish an elaborate system which most people choose not to use would be expensive. I hope the IRS will do careful surveys before it moves ahead on this type of program.

One more note of caution. Lower rates with few, if any deductions, will make life simpler for many people. It will also assist the IRS with its tremendous administrative burden. I believe the IRS does an excellent job administering a very complex law. If a tax reform proposal passes, the IRS would still have a very complex law and tremendous job to do. I hope this Committee and the Congress will make sure that the IRS is adequately funded and staffed. This bill, if it passes, will not relieve the Service of very much of its work. The IRS is underfunded and understaffed right now.

I should remind this Committee that "higher" rates of tax are only relative. The effective rates of tax are only relative. The effective rates of tax in the proposals are not dramatically different than before. After we have had them for several years, people will say they are too high. That happened in 1964 when we reduced rates dramatically. People were pleased for a short while and then began the pressure of more and more relief. It will happen again.

Also, I want to remind the Committee of Mrs. Evelyn Gregory. Everyone remembers the famous case of Gregory v. Helvering. It stands for the principle that we look to the substance of the transaction rather than its form.

Mrs. Gregory went through a very elaborate series of transactions intended to avoid a dividend tax. Mrs. Gregory did this in 1928 when the maximum rate was 25%. Therefore, I warn you that even in the face of lower rates, taxpayers will not stop their efforts to reduce their taxes by more than you feel appropriate. You must draft the law carefully, and we need an adequately staffed IRS to operate the system.

The CHAIRMAN. Dr. McDaniel.

STATEMENT OF PAUL R. McDANIEL, PROFESSOR OF LAW, BOSTON COLLEGE, NEWTON, MA

Mr. McDANIEL. Thank you, Mr. Chairman. I appreciate the invitation of the committee to appear before you this morning. In the summary of my written statement, I would like to focus on three points: First on the differing effects of the President's proposals on real estate generally; second, on tax shelters; and third, if time permits, on the rehabilitation tax credits. First, with respect to the impact on real estate generally, I think it is fair to say that the President's proposals will have differing impacts on differing kinds of real estate investments. And in my statement, I divide those into three very broad categories.

In the first category, with respect to commercial real estate, such as office buildings, shopping centers, and the like, the question is whether the at-risk rules—those rules that are most likely to have a major impact on real estate investment—would have a deterrent effect on investment in that kind of real estate. It is probable here that our experience with respect to the application of the at-risk rules to equipment leasing and research and development costs will be instructive. In those areas, where we have had at-risk rules for a number of years, we have found the investments have not stopped, whether through tax shelter vehicles or otherwise, because investors have been willing, in fact, to go at risk with respect to those investments. Now, in a shopping center or an office building with two or three prime tenants lined up on long-term leases, you are in a situation very similar to the R&D or the equipment leasing investment; and it may well be that investors would be willing to go at risk since they would have highly creditworthy tenants in the buildings.

When you move to upper and middle income rental housing, the matter becomes more complex. Here, you do not have long-term creditworthy tenants, such as General Motors or IBM, but instead shorter term and multiple tenant situations. Investors may be less willing to go at risk, and one of two likely responses can be predicted. One, rents will rise to provide the requisite amount of income to establish at-risk basis for the investor; or two, the mortgage amortization schedules will be revised in order to permit the investor to have a sufficient amount of at-risk basis during the course of the investment.

With respect to low-income housing, it is probably that the at-risk rules would end low-income housing programs in the country as we have them at the present time. It seems very unlikely that investors would be willing to go at risk with respect to those investments. Rents, by law, cannot be adjusted to provide an adequate rate of return to investors, and it seems unlikely that the mortgage amortization schedules therefore can be adjusted. So, in this situation, I think the committee is going to have to consider either exempting low-income housing from the at-risk rules or providing an alternative form of subsidy, perhaps a direct refundable tax credit to the builder-developer to provide funds for this program.

Second, in the area of tax shelters, the real estate tax shelter will undoubtedly continue. This is because the President has decided that one of the fundamental building blocks of tax shelters will continue, namely the improper measurement of income. By the President's decision not to use economic depreciation, we have guaranteed one of the building blocks of the tax shelter will remain. And, as the Treasury data shows, the present value of the depreciation schedule plus indexing of depreciation for inflation can under some circumstances be greater for the tax shelter investor than under existing ACRS rules.

There is a serious and, in my view, fatal flaw with respect to the President's proposals that are probably going to make tax shelters more attractive, and that is the decision to index depreciation but not index debt which is used to finance the acquisition of the project. By this proposal of the President, it is quite possible to borrow and invest in an asset, realize no economic gain or loss on either the asset side of the transaction or on the debt side of the transaction, and still walk away with a check from the Treasury Department. I can illustrate that with a simple example later, if the committee would be interested. But it seems likely this phenumenon will be the new building block on which real estate tax shelters are created and will be a highly lucrative one.

There are other possible responses to the tax shelter problem. The President has recommended some. I would suggest that the committee consider two others: one, a proposal which was made earlier, the limitation on artificial losses proposal, which restricts deductions to the amount of income generated by a particular project; or alternatively, I would suggest that we eliminate the selling of tax benefits which goes on through tax shelters by providing a refundable tax credit directly to the builder-developer, the one who is really carrying on the economic activity in the project. Thank you, Mr. Chairman.

The **Chairman**. Thank you.

[The prepared written statement of Mr. McDaniel follows:]

HEARINGS ON THE SUBJECT OF TAX REFORM
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

July 16, 1985

Paul R. McDaniel

Professor of Law

Boston College Law School

I appreciate the invitation of the Committee to testify in its hearings on the impact of the President's tax reform proposals on housing, real estate and rehabilitation.

I am Professor of Law at Boston College Law School and am Of Counsel to the law firm of Hill & Barlow, Boston, Massachusetts. In my testimony today, I am not representing the interest of any client, institution or group.

I. THE PRESIDENT'S PROPOSALS

The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity contain a number of provisions that will affect housing, real estate and rehabilitation of older buildings. The period of time over which a building could be depreciated would be established at 29 years (as compared to 15 years for low income rental housing and 19 years for other depreciable real estate under existing law). The basis of depreciable assets (but not associated debt) would be indexed for depreciation. While preferential capital gain rates would be retained for land, all gain on the sale of depreciable real estate would constitute ordinary income. The at-risk rules would be extended to real estate. A limited partner's distributive share of interest expense incurred by the partnership would be treated as investment interest and would be deductible by the limited partner only to the extent of investment income plus $5,000. As under present law, the minimum tax would continue to apply to the excess of accelerated over straight-line depreciation and to the excluded portion of long-term capital gains.

The President's proposals also call for the recapture of "excess depreciation" taken by taxpayers between 1980 and 1986. The excess depreciation is the amount of depreciation taken by the taxpayer over, in the case of depreciable real estate, a 40-year life. The purpose of the recapture provision is to prevent a windfall to taxpayers as the top marginal rates for individuals are reduced from 50% to 35% and from 46% to 33% for corporations.

The existing 15, 20 and 25% tax credits for rehabilitation of older and certified historic structures would be repealed.

It is quite difficult to access the overall impact of the President's proposals on investment in real estate and rehabilitation of older structures. This difficulty arises because a number of the proposals move in opposite directions in their impact on real estate investment. Moreover, because of that fact, different investors will face different tax results depending on the investment objectives they may have, i.e., whether they are long-term or relatively short-term investors. The following analysis suggests some possible effects on different types of real estate investments. It should be noted, however, that the analysis takes into account only those provisions that have a relatively direct impact on real estate investment; it does not take into account the effect reduced marginal rates would have on investment in real estate.

II. REAL ESTATE AND HOUSING

It appears likely that the proposals submitted by the President will have different effects depending on the type of real estate investment involved. The underlying reason for these differing effects is the failure by the President to provide a neutral system of depreciation and indexing which would have insured that all real estate investments were subject to the same tax regime. Had the President adopted the recommendations of Treasury 1 to employ economic depreciation for all assets and to index both the basis of assets and debt, then the distortions among types of real estate investments that are going to continue would have been eliminated. As a result of the decision not to adopt economic depreciation and full indexing of assets and debt, the President's proposals were necessarily driven to a series of second-best responses to attempt to prevent abuses arising from the failure to adopt provisions that would correctly measure economic income. As is the case of all second-best tax solutions, a new set of distortions and complexities will inevitably be created.

A. Commercial Real Estate

In the case of commercial (non-rental housing) real estate such as shopping centers and office buildings, a number of the President's proposals have an impact on investors.

Depreciation. As noted above, the President has proposed that the costs of depreciable real estate be written off at a 4% declining balance rate over a 29-year period. These rules would replace the existing 15-year period and 200% declining balance method for low-income housing and the 19-year period and 150% declining balance method for other depreciable real estate. The basis of depreciable assets would be indexed for inflation but the debt used to acquire the assets would not be indexed for inflation, i.e., a taxpayer would be entitled to deduct the full amount of nominal interest incurred on debt used to acquire depreciable real estate.

As the Treasury analysis indicates, under certain assumptions the present value of the new depreciation schedule plus indexation can actually exceed the present value of unindexed depreciation under ACRS. The critical assumptions in the Treasury analysis are that an investor holds a piece of real estate for 29 years and has a 4% after-tax real rate of return. If an investor held a property for less than the 29 years assumed by the Treasury and/or had an after-tax real rate of return higher than 4%, the present value of the depreciation deductions would not be as great as reflected in the Treasury figures.

Nonetheless, the Treasury data do indicate that, in present value terms, investment in real estate may not be significantly affected by reducing the acceleration of depreciation from the existing ACRS rules when the change is coupled with indexation of basis for inflation.

However, permitting indexation of the basis for real estate (or any other investment) without requiring the indexation of debt is a serious flaw in the President's proposal. A simple example will illustrate the point. Suppose a taxpayer invests in a piece of vacant real estate at a cost of $100. He holds the land for one year during which time the rate of inflation is 10%. He has borrowed the $100 to acquire the land at a 10% interest rate. At the end of the year, under the President's proposal, the taxpayer could adjust the basis of the land for inflation, sell it for $110, and realize no gain or loss. On the other hand, he would be entitled to deduct the full $10 of "interest" even though obviously he has incurred no interest cost in real dollar terms. Or, to put the matter another way, the taxpayer in a transaction in which no economic gain or loss was recognized on either the asset or the debt side of the equation nonetheless walked away with $5 from the Treasury solely from the tax advantage of being able to deduct nominal interest while being able to index basis for gain or loss purposes.

The same analysis holds true in the case of depreciable real estate. Here the asset which the taxpayer has acquired is a pot of depreciation deductions which will taken into account over time. Although the computation of the benefits is more complex than in the example using vacant land because depreciation deductions are taken over time, the basic economic point remains the same. A taxpayer will realize a tax profit from the Treasury even if his economic depreciation exactly corresponded to tax depreciation.

I recognize that the proper indexation of debt for inflation is a complex matter. Treasury 1 had proposed to index both assets and debt. The Treasury 1 proposal, insofar as it applied to debt, had its defects but it represented an attempt to provide a practical, second-best approach to the problem. With some modification, I believe it could provide satisfactory, if not perfect, results. It may be, however, that present learning does not give us workable rules for the correct treatment of debt in an inflationary economy. If that is the case, then introduction of indexation indexation of the basis of assets for inflation should be deferred until we have found a workable solution for the debt side of the transaction. Indexation of asset basis only will simply introduce into the economy a different set of distortions than we experience at the present time from the failure to index both debt and assets. It is likely that the new set of distortions will prove more undesirable than those experienced under present rules which index neither assets nor debt.

Accordingly, I recommend to the Committee that if indexation on the asset side is to be adopted, then debt must also be indexed for inflation to prevent new investment decision distortions and inequities. If a workable method of debt indexation cannot be developed at the present time, then indexation on the asset side should not be adopted until such time as indexation of debt can be implemented in a workable manner.

The President's proposals with respect to depreciation implicitly assume that a subsidy should continue to be given for investment in depreciable assets. That subsidy is given in the form of acceleration of depreciation over that which would be allowed in the case of economic depreciation. As is well-known, the effect of accelerated depreciation is to provide a subsidy to taxpayers in the form of interest-free loans. Although the demands of tax simplification and tax equity require the adoption of economic depreciation, tax policy objectives can be accommodated to accelerated depreciation. That is to say, tax inequity can be avoided even if Congress decides to provide a subsidy through the tax system in the form of accelerated depreciation. Legislative action which the Committee should consider must begin with the recognition that a taxpayer is being granted a loan from the government in the early years of ownership of the asset. That loan is repaid in later years as accelerated depreciation falls below economic depreciation. The appropriate tax policy response, if this form of investment subsidy is adopted, is to impose an annual interest charge on the tax that would have been paid had economic depreciation (or a reasonable equivalent thereof) been employed. (The technique suggested here is similar to that involved in the case of interest-charged DISCs.) The interest would, of course, be deductible since it would represent a cost of producing income. This treatment would be entirely consistent with normative income tax measurement rules. That is, receipt of a loan in and of itself does not represent income to the taxpayer. However, income does result if the taxpayer is not charged a market rate of interest. Accordingly, tax equity objectives can be achieved in the case of the subsidy provided by accelerated depreciation if an interest charge at the applicable federal rate is imposed on the loan that is effected through accelerated depreciation.1/

1/ Of course, there may be other objections to accelerated depreciation viewed from spending program criteria, e.g., the amount of the tax loan is a function of the taxpayer's top marginal rate, no loans are extended to nontaxpayers, the loans are unsecured, etc. These are problems of program design rather than of income measurement, however.

Recapture of Excess Depreciation. The President proposes to recapture the benefits of "excess depreciation" for property placed in service by taxpayers between 1980 and 1986. As noted above, taxpayers received an interest-free loan when they took accelerated depreciation during those years. The amount of that loan was a function of the taxpayer's marginal tax rate, typically 50% for individuals and 46% for corporations. The tax loan, at the time it was taken out, was required to be repaid when depreciation deductions fell below economic depreciation. As long as the taxpayer's marginal tax rate was the same at that time, the full amount of the loan would be repaid to the Treasury. By virtue of the President's proposals to reduce the top marginal rates for individuals to 35% and the top corporate to 33%, the tax loans taken out through accelerated depreciation between 1980 and 1986 would not be recovered in full by the government; instead, a part of the loan would in effect be forgiven because the loan repayment would be made by using a 35% or 33% rate whereas the loan was taken out by using a 50% or 46% rate. It is to prevent this loss of 40% of the loans that were made through accelerated depreciation that the President's recapture proposal is intended to address.

The President's proposal is conceptually sound in many respects. However, in the case of real estate, it does have some effects that should be noted. In the first place, the recapture proposal may accelerate the repayment of the loan by a significant period of time. The repayment of the loan is to be made under the

President's proposals in 1986, 1987 and 1988. Real estate leases may be longer than five years and the crossover point between tax depreciation and economic depreciation would likely not occur until later than 1988 for many assets placed in service during 1980-86. Moreover, it should be noted that the definition of excess depreciation of recapture proposal means that taxpayers will be subject to the recapture rule even if they have taken straight-line depreciation with respect to their property. This result occurs because the economic depreciation figure used for depreciable real estate is 40 years whereas tax depreciation was computed using a 15, 18, or 19 year life. The recapture proposal also has the effect of converting what would have been capital gain income into ordinary income. This result occurs because, under existing law, a investor who takes straight-line depreciation with respect to real estate is not subject to any recapture upon sale or exchange of the property. But, as noted above, the recapture of excess depreciation applies even if the taxpayer has taken straight-line depreciation.

While the President's recapture proposal is sound in conception, nonetheless the Committee may want to consider the above situations in which it would significantly alter the expectation of investors who acquired depreciable real estate during the 1980-85 period.

At-Risk Rules. The President proposes to extend the at-risk rules to depreciable real estate. As a result, taxpayers would be entitled to obtain depreciation and other deductions only to the extent of their equity investment in the property. In the case of commercial real estate such as shopping centers and office buildings a number of responses might be made by investors. For example, if a particular project such a shopping center or office building, can line up prime tenants on long-term net leases, investors might be willing to be at-risk with respect to the underlying mortgage indebtedness. They would be willing to take this step if the credit worthiness of the prime tenants assures that debt service payments would be made out of cash flow generated by the project. It is the case, however, that many office building leases provide for an initial term of, say, five years with option in the tenants to renew the leases for additional specified periods. Whether investors would be willing to be at risk with respect to the mortgage in such situation is more speculative.

The willingness of investors to go recourse where a high-quality lessee is involved in the transaction has been amply demonstrated in the case of equipment leasing transactions. The at-risk rules have applied to equipment leasing transactions since 1976. Nonetheless, large scale equipment leasing goes on despite the at-risk rules. This result has occurred because, where a high-quality lessee is involved, the investor is willing to be at-risk with respect to the mortgage indebtedness because of the credit worthiness of the lessee. It is possible that this experience would be replicated in the case of single-tenant buildings. But, real estate mortgage loans are typically for a much longer period of time than equipment loans. Investor willingness to assume liability for the longer time period is uncertain.

Investors in some projects may be unwilling to be at risk with respect to the mortgage financing. Here, it may be possible to restructure the ratio of equity investment to debt and to modify the loan principal repayment schedule to avoid loss of deductions to investors.

It is likely that in marginal cases the at-risk rules would deter an investor from going into a particular project. This result could occur where the builder/developer was unable to find prime tenants who were willing to enter into relatively long-term net leases. I cannot predict the magnitude of this response. This result, if it were to occur, would be consistent with the underlying economic premise of the President's proposals, i.e., that the tax system should not be used to subsidize marginal investments and provide the profit that otherwise would not be present from a transaction which required market rates of return to attract investors.

Investment Interest Limitation. The President has proposed to treat as investment interest a limited partner's distributive share of interest expense incurred by the partnership. Investment interest would be allowed as a deduction only to the extent of the investor's investment income plus $5,000. It is unlikely that this proposal would have a significant impact on investors in real estate partnerships. This result should be anticipated because of the method of computing investment income from real estate under Section 163(d). In determining net rental income from real estate which is subject to net leases, straight-line depreciation is employed. As a result, there is generally a sufficient amount of rental income under this definition which can shelter investment interest.

Repeal of Section 1231. The President's proposals would repeal Section 1231 and thus treat the gain on the sale of depreciable real estate as ordinary income in its entirety. Under present law, the gain is subject to the recapture rules only if accelerated depreciation has been taken; the balance of the gain is provided capital gain treatment. If straight-line depreciation has been taken, no recapture is involved. In the case of long-term investments, it is probable that the change would have little impact on real estate investment. A tax due in 20 or 30 years has little present value as a potential liability. However, the proposal could have an impact on transactions in which the investors look to realize real appreciation in value from the investment and contemplate a sale within 5 to 7 years. To some extent, of course, indexing of the basis of the asset for inflation would offset the loss of capital gain treatment.

It is clear that proper tax rules require the recapture of all depreciation previously taken as ordinary income, whether that depreciation has been taken on a straight-line or accelerated basis. Once that step has been taken, then arguably the gain in excess of original cost should be treated as capital if the President's proposal to retain preferential treatment for other types of capital assets is accepted. However, losses on such assets should then be treated as capital losses rather than as ordinary losses as under present law.

Because the President's proposal retains ordinary loss treatment for the sale of depreciable assets, the treatment of gains and losses from depreciable real estate is consistent. That treatment is not, however, consistent with that of gains and losses from other types of capital assets.

Minimum Tax. The President's proposals would strengthen the minimum tax somewhat and would apply to the excess of accelerated over straight-line depreciation and to capital gains realized in the case of gains from the sale of land. Given the small revenue impact of the President's minimum tax proposal overall, it is unlikely that changes in the minimum tax would have any significant impact on investment in commercial real estate.

B. Rental Housing (Other than Low Income Housing)

Depreciation and Indexation. The impact of the revised depreciation rates and indexation of basis should be similar to that discussed above with respect to commercial real estate.

At-Risk Rules. The at-risk rules could have a significant impact in the case of rental housing. Unlike commercial real estate, it is generally not possible to sign residential tenants to long-term, net leases. The uncertainty of the occupancy rates and the credit worthiness of individual tenants thus would likely make assumption of mortgage liability by investors distinctly more undesirable than in the case of commercial real estate. The question then is whether rentals can be adjusted upward to provide an adequate cash flow to carry a higher early debt service in order to provide investors with sufficient at-risk basis against which to offset deductions.

It is possible that adjustments can be made so that rental housing investments will continue to be attractive despite the existence of the at-risk rules. Thus, in some recent transactions, institutional lenders reportedly are requiring that individual investors in rental housing make an equity investment ranging from 30 to 50% of the cost of the project. In such cases, the equity investment would appear to provide sufficient at-risk investment to support tax losses for the initial years of the investment. Then, the debt service on the nonrecourse loan would have to be set so that, once the investors had used up their own equity investment by taking tax losses, additional at-risk basis would be generated to support depreciation and other deductions in later years.

Of course, even assuming that the at-risk rules would have an adverse impact on investment in residential real estate, the further issue is whether the federal government desires as a policy matter to subsidize lower rents in rental housing ranging from the middle to the luxury categories. Again, the President's proposals assume that if the investment is not supported by adequate market rentals, then the tax system should not make the investment economically viable. This is simply another way of stating that, in the President's view, rental subsidies for middle to luxury level housing do not have a sufficiently high priority to justify federal expenditures, at least where the investor is unwilling to place his own funds at risk in the project.

Other Limitations. The other limitations discussed above with respect to commercial real estate are equally applicable to investment and rental housing and the considerations appear to be similar.

C. Low Income Housing.

Depreciation and Indexation. The President's proposal eliminates the present differential between low income housing and other rental housing in terms of depreciation rates and periods. Under existing law, low income housing is placed in the 15-year cost recovery class and a 200% declining balance rate may be used whereas other rental housing is in the 19-year class and is limited to a 150% declining balance rate. Under the President's proposals, all depreciable property, including low income housing, would be in the same depreciation class and would use the same depreciation rate.

Whether the Committee wishes to retain a differential between low income housing and other rental housing is a matter of federal housing policy, not tax policy. If it is deemed desirable to maintain a distortion in favor of investment in low income housing, then presumably a 25-year class could be created for low-income rental housing and/or a more accelerated rate of depreciation could be provided.

At-Risk Rules. The application of at-risk rules to low income housing projects would probably terminate them. This is because the rents that may be charged in subsidized low income housing projects are limited and are well below market rentals. As a result, rents cannot be raised to provide the yield necessary to attract investors. Moreover, the high risk nature of such investments would make it unlikely that investors would be willing to go at-risk on the mortgage that finances the project.

Thus application of the at-risk rules to low income housing really involves a determination whether the federal government wishes to continue the tax subsidy to low income housing that is essential if any low income housing is to be built in the country. While the tax subsidy for low income housing repeatedly has been demonstrated to be highly inefficient, nonetheless it is the only federal subsidy that enables low income housing to be built. There is a further question whether a more efficient subsidy, tax or direct, could be designed to support the construction of low income housing, a point which is discussed in more detail below.

It would, of course, be possible to exempt investment in low income housing from the at-risk rules. The need to exempt low income housing, however, should not be used as a justification to retain the exemption from the at-risk rules for all other residential rental real estate and commercial buildings. While federal tax subsidies are undoubtedly required to supplement the lower rentals received in the case of low income housing, there is no similar justification to require subsidization of rentals paid by tenants in shopping centers, office buildings, and luxury apartment houses. A 1977 study by the Congressional Budget Office, "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives" revealed that only 18% of federal tax benefits for real estate actually went to low income housing. In order to benefit low income housing, it is therefore quite unnecessary to provide the same benefits to other types of depreciable real estate.

III. TAX SHELTERS

The question may be asked whether the President's proposals to modify the depreciation rules for real estate and to reduce top marginal rates for individuals will eliminate the real estate tax shelter. The short answer is that they will not, although the pricing of tax shelter investments will undoubtedly be affected. One fundamental building block on which a tax shelter is based is the mismatching of income and expenses which results from the use of accelerated deductions for depreciation in the case of real estate. So long as this condition exists, tax shelters will be with us. Moreover, as noted above, the President's proposal to index the basis of assets for depreciation but not debt used to finance the acquisition of that asset may actually enhance the attractiveness of the real estate tax shelter under certain circumstances.

There are several responses that the Committee can make to deal more effectively with real estate tax shelters. Those responses may be briefly summarized as follows:

Economic Depreciation: Adoption of economic depreciation, as proposed in Treasury 1, coupled with indexation of both debt and assets would eliminate the real estate tax shelter. Real estate investments would only be undertaken if they held out the promise of true economic gain. The sale of tax subsidies would be, by definition, eliminated.

The failure to adopt the approach of Treasury 1 inevitably drives policymakers to second-best solutions. The President's proposals with respect to the at-risk rules and investment interest are reflections of second-best approaches and they carry with them the difficulties discussed above. Other second-best solutions that should be considered by the Committee include:

Limitation on Artificial Losses: The proposal has been made in the past that taxpayers should only be entitled to deduct tax losses from an investment to the extent of income generated by that investment. This would appear to be a more effective response to the tax shelter problem than any of those proposed by the President. It would cut across all types of real estate investments in what would appear to be a more neutral manner than do the President's proposals. Utilization of this technique should be given serious consideration by the Committee.

Limited Partnerships Treated as Corporations: It would also be possible to attack the tax shelter problem by treating more limited partnerships as corporations and thus prevent the flow through of tax benefits to individual investors, at least insofar as those are associated with debt incurred by the entity. Treasury 1 proposed that all limited partnerships with more than 35 limited partners be treated as corporations. Alternatively, the Committee could consider treating all limited partnerships as corporations if they are required to register with the Securities and Exchange Committee or with a state regulatory commission.

Rather than considering second-best tax solutions to the tax shelter problem, the Committee could revise the method of providing the subsidies on which tax shelters are based. A tax shelter is created by a real estate developer/builder because of the need or desire of the developer to realize his development fee upfront. In a typical tax shelter transaction, the financing obtained for the project will pay from 90 to 100% of the actual costs of building the project. However, the financing will not pay the developer's and builder's fees. In order to obtain their fees, the builders and developers sell the tax benefits associated with the project to the investor group.

There are other ways to provide the federal funds to the builder/developer that would not require the introduction of the investor group into the picture. Congress could provide a refundable tax credit to the builder/developer equal to, say, 10% of the costs of the project which are financed by third party lenders and independent investors. The credit should be refundable and taxable. The building costs would be depreciated using economic depreciation. Providing a refundable credit to the builder/developer would insure that he or she would get a fee up front and would eliminate the need or ability of the builder/developer to sell tax benefits. In turn, this action would eliminate the need for investors who presently siphon off a significant part of the tax benefits for themselves. It would also eliminate the need for syndicators, lawyers and accountants who likewise siphon off a significant percentage of the tax benefits. The use of the refundable tax credit thus would make federal subsidies for real estate more efficient and the tax system more equitable.

Of course, as an alternative, Congress could consider the provision of direct payments to builders/developers in lieu of the tax credit approach.

Either of these actions would eliminate the real estate tax shelter since investors would be confined to economic depreciation and the builder will have realized his fee in the form of a refundable and taxable tax credit or direct grant.

IV. REHABILITATION TAX CREDITS

The President proposes to repeal the tax credits provided for rehabilitation of older structures. Present rules provide a 15% tax credit for rehabilitation of property which is more than 30 years old, a 20% credit for property which is more than 40 years old, and a 25% tax credit for certified historic structures. In the case of property qualifying for the 15% and 20% tax credits, the basis of the property must be reduced by the full amount of the credit. In the case of certified historic structures, the basis of the property must be reduced by one-half the amount of the credit.

In assessing the President's proposals to repeal the rehabilitation tax credits, it is necessary to distinguish between tax policy issues and federal subsidy issues.

From the standpoint of tax policy, the treatment of the 15% and 20% credit property presents no income measurement problems. Because of the full basis reduction that is required, the amount of the credit is included in income over the depreciable life of the property. That is exactly the same result that would occur if the federal government made a direct grant equal to 15% or 20% of the rehabilitation costs. The tax policy issue with respect to certified historic structures is that the basis is reduced by only one-half the amount of the credit and thus, in effect, only one-half the amount of the subsidy is included in income. If the full amount of the credit were required to be included in income in the case of rehabilitation costs for certified historic structures, then tax policy income measurement concerns would disappear. (As noted above, the selling of these subsidies in tax shelter operations could remain a concern for tax policy even there are no income measurement problem, and hence no tax equity issues, involved.)

If the Committee were to require a full basis adjustment for the tax credit for rehabilitation costs with respect to certified historic structures, then the issues presented by the rehabilitation tax credits would be exclusively those involved in providing federal subsidy. Congress must be satisfied that there is a need to provide a federal subsidy for rehabilitation of older and historic structures because there is a market deficiency which would drive investment away from rehabilitation and toward new construction. This might be a matter of special concern in the case of certified historical structures where it is perhaps less than clear that the market would place the requisite value on maintenance of historically significant buildings.

If the tax subsidy remains, however, there do appear to be some problems of program design and control that the Committee should investigate. For example, in order to qualify for the credit for rehabilitation of historic structures, the project must be certified by the Department of the Interior. There is a marked lack of incentive for the Interior Department to deny classification as a certified historic structure in view of the fact that the certification has no impact on the Department's budget. There is thus very little assurance that costs of the program are being controlled.

Two approaches could be taken by Congress to provide more effective controls on the federal spending run through the rehabilitation tax credits:

1. The current year direct budget for the Department of the Interior could be charged by the amount of the credits which it had approved for the prior year. This would provide an incentive for careful evaluation of proposals to classify structures as historic.

2. Alternatively, Congress could put a cap on the amount of allowable credit which could be approved by the Department of the Interior in any one year. For example, if Congress decided that it wished to spend no more than $100 million per year through the tax credit for rehabilitation of certified historic structures, that ceiling could be placed on proposals that could be approved by the Department of the Interior. This step would force the Department to establish priorities among competing projects and make sure that federal funds were expended only for the highest priority projects from the standpoint of their historic significance.

CONCLUSION

In very broad terms, the President's proposals call for the elimination or reduction in numerous tax expenditures, including those provided to real estate investment. Implicit in the revenue neutrality stricture which the President has imposed is the further proposition that all revenues derived from cutting back or repealing tax expenditure programs should be used to finance rate reductions for individuals and corporations. Congress, of course, when it repeals or cuts back a tax expenditure always has three choices before it: it can use the revenues to finance rate reductions; it can use the revenues to reduce the deficit; or it can use the revenues to finance alternative direct expenditure programs. At the heart of the debates that the President's proposals have generated lies the question whether the subsidies provided through the tax system should be cut back or repealed, and, if so, whether the revenues should be devoted entirely to rate reductions rather than to, say, deficit reduction.

As has been demonstrated above, in the case of real estate (and in the case of other industries as well) subsidies can be provided through the tax system which are consistent with principles of tax equity. However, it not possible to do so and provide the magnitude of rate reduction called for by the President without significantly increasing the budget deficit.

It is clear that cutting back or removing the existing tax subsidies for real estate would require the restructuring of real estate transactions and could eliminate marginal projects. But, as noted above, this result would be entirely consistent with the underlying economic philosophy of the President's proposals to let the marketplace determine the structure and extent of real estate investment unaffected by subsidies provided through the tax system.

The **Chairman**. Mr. Cohen, let me ask you to clarify a statement. Did I sense that you don't like using the Tax Code for incentives at all, or did you mean that just in the real estate field? I noticed that you made reference to finge benefits also.

Mr. **Cohen**. Mr. Chairman, I don't like it at all in the sense that it does create a tremendous administrative burden. On the other hand, I recognize that if they are broadly based and if the committee has determined that it is more efficient and more effective to do it in the tax code, that they ought to do it through the tax system. But I think it ought to be a conscious decision. Unfortunately, in the past, we have willy-nilly, without analyzing administrative burdens or other types of problems created—expertise, for example, lack of—just dumped the burden on the Internal Revenue Service. In fact, I have said before some of these committees that if you constantly did that, you could do away with 11 departments and put everything in the Internal Revenue Service.

The **Chairman**. In other words, you are saying it is all right to use the Tax Code for incentives if, one, they are socially worthwhile?

Mr. **Cohen**. Broadly based.

The **Chairman**. Is that the same thing?

Mr. **Cohen**. And broadly based, I would say. Yes.

The **Chairman**. The historic rehabilitation credit is not what you would really call broadly based.

Mr. **Cohen**. No, and in fact, I said that if you are going to repeal it, you ought to——

The **Chairman**. Should we repeal it because it is not broadly based? What are you recommending?

Mr. **Cohen**. I am recommending that it is a socially desirable program; and if you are going to repeal it, then you and other Members of the Congress ought to take into account, in your other activities on other committees, and in the appropriations process. There are many things in the Internal Revenue Code today that just can't be jettisoned, as Dr. McDaniel pointed out a moment ago in the low-cost housing area——

The **Chairman**. Let's go to the definition of broadly based because, hopefully, anything we encourage with the Tax Code is socially worthwhile. And this is a matter of judgment, but I don't think we consciously do it thinking, aha, this isn't socially worthwhile, but let's do it anyway. So, come to the broadly based part of it. What do you mean by broadly based? How many people does it have to touch? What is that definition?

Mr. **Cohen**. I think you must look at the administrative aspects of the Internal Revenue Service, and that is not done up here very often. Each of the very specialized kinds of deductions—in the real estate area we are talking of a much broader area, but when we are talking about very specialized deductions, you don't have in the Internal Revenue Service the expertise that they do in other departments in particularly narrow-based areas.

The **Chairman**. Does broadly based mean the number of people who use it or the number of people who benefit from it? What does the definition mean? Forgetting for the moment the problems of administering it. Does there have to be 10 percent beneficiaries? Or, like in health insurance, 80 percent beneficiaries? Or can it be

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a very narrow base of beneficiaries but, indeed, one that is regarded as socially worthwhile—and low-income housing is one. That is relatively narrow base of beneficiaries, relatively speaking, but most people in the Congress regard it as a worthwhile base of beneficiaries.

Mr. **Cohen**. As Dr. McDaniel said, there is an equally efficacious way to do it directly by subsidy.

The **Chairman**. We are going to get to that in a minute, but first, I want to know if it is all right to call something broadly based that only 5 or 10 percent of the people benefit from?

Mr. **Cohen**. I would rather not, but that is a question of judgment. Each of these is a judgment call. I can't say that there is any magic administrative answer that I can give you that if it applies to 500,000 people it is OK, and if it only applies to 50,000 people it is not.

The **Chairman**. So, that is a judgment call for Congress, too, then?

Mr. **Cohen**. Absolutely. Absolutely. The difficulty is that we haven't looked at it very often. Here is a chance to look at it.

The **Chairman**. Mr. Williams, let me ask you a question, if I might?

Mr. **Williams**. Sure.

The **Chairman**. The at-risk provision, at the moment, applies pretty much to all activities other than real estate and equipment leasing.

Mr. **Williams**. That is right.

The **Chairman**. And indeed, if we were to have a level playing field, it would be easy to make it level by extending it to equipment leasing and real estate. What is the justification in your mind for seperating out real estate—and you can comment on equipment leasing if you want—from almost everything to which the at-risk rules do apply?

Mr. **Williams**. I don't know that much about equipment leasing so anything I would say there would be unusually ignorant, not just my normal standard of ignorance. [Laughter.]

But as to at risk, real estate as you know has been historically financed on a project-by-project basis. It is not financed on a corporate basis. It is typically done by local and regional developers. It is very capital intensive. It tends to be large dollars, in relation to any standard you may use. If you are the only developer in Roswell, NM, and you build a small warehouse there in relation to that activity, it is large dollars. And therefore, it doesn't have access to equity capital. There has never been a big equity market for real estate a thin tier of upper level, 10 or 15 percent of the dollars. Lenders historically have underwritten real estate on a project-by-project basis. They have very strict underwriting standards. Admittedly, some have slipped in the Thrift industry, I think, here in the past 2 or 3 years, but in the main, it has been a very disciplined underwriting. That is why in the 1974-75 real estate problem, you didn't have a lot of foreclosures on large buildings because the lenders have very strict underwriting criteria. So, there are very strong lending standards generally applied. Historically, those have been without any personal liability on the part of the developer because, again, the people who would be willing to undertake that kind of risk typically are those who don't have anything to risk. That is, if someone with no net worth is going to build a $50 million office building in Dallas, he will sign anything. It doesn't matter because he is not good for any of it, and the lender underwrites it. So, what you are doing is raising the risk profile of those who are making the most significant investments in real estate today. And I have a number of friends of mine in the business say that if that is the case, I will go out of the business. I am not going to risk everything I do, because I do have something at risk, on every deal that I do. So, I think it just doesn't make any sense. I don't know about a level playing field and fairness and all that. I think there is another way to deal with these shelter abuses that have occurred with financing. As was mentioned earlier, the Treasury invites and exception in at risk for third party institutional debt. I think that is a very appropriate way to do it. If the problem really is jacked-up debt, for example, on wraparound financing or vendor financing in order to generate deductions, let's deal with that, but let's don't change the whole industry that has been patterned in one way for 40 or 50 years and jump the risk of everybody involved in the industry more than it already is for no good reason. It doesn't raise that much revenue, and I think it will deter people who really can afford to take the risk to be in it. I am sorry. That is more than you wanted to hear on that.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Let me pursue that just a minute. It seems to me that if you follow Treasury's viewpoint here, you still get the same buildings built, but they are built by extremely wealthy individuals who can take on that kind of a risk or giant corporations. But the typical entrepreneur who has been doing it, doesn't do it any more. So, it seems to me that the way to attack the inflated nonrecourse loan is to go to third parties, if you have a recognized financial institution—a bank, an insurance company, an S&L, whatever it might be—who would not be prone toi give that kind of an artificially high loan.

Mr. WILLIAMS. Yes, sir.

Senator BENTSEN. And I think that is probably the way to handle this situation. Some of the things that concern me are that there is no question in my mind but that real estate has the biggest adjustment of any one sector under this particular piece of legislation. You are going to have some very major economic dislocations take place, and I am concerned, too, about some of the problems that we have with financial institutions today; and as you see these property values go down—as they will if this is passed in its present form—I think you are going to see some more failures—substantial failures—in financial institutions. The one other is the one that I guess everybody here is talking about and that is favoring for social purposes the rehabilitation of historical structures. Is someone differing with that point of view? I think you get beyond the market forces in that one because you have a situation with downtown rehabilitation where you have got all the utilities and your transportation there, and I don't think that is really figured in when you move out to suburbia. The overall bond issue for the city normally takes care of that. So, I think you have a very fine and good economic purpose to try to encourage the rehabilitation of those old buildings. I am one who thinks that in some instances we do have to have those incentives in the system. Now, on the recapture of the accelerated depreciation, I am one who fought against taking buildings down to 15 years. I thought that was too sweet a deal. And Mr. Williams, I would agree with you that in Houston, a good part of what is happening with the vacancies is what has happened to the energy market, but I think that is also coupled with too sweet a deal for real estate on depreciation on major commercial buildings. The problem is now going back too far the other way. That is what we are prone to do here. In looking at recapture, that is a situation where it is a retroactive action. Can you tell me what the difference is? I think what they did—Sheldon, you were talking about 2:00 in the morning. I think it was about 2:00 in the morning, and all of a sudden they realized they were short.

Mr. **Cohen**. It is a plug, sir.

Senator **Bentsen**. They didn't have enough money. I think they reached up there and picked up $57 billion on recapture and they put it on ACRS, and they ignored all the other items under section 312. If the rationale applies to one, it applies to the rest of them. I don't understand. Can you tell me why it shouldn't apply to all of them?

Mr. **Cohen**. One of my partners calls it "a windfall without profits tax." [Laughter.]

That makes it very difficult for people to know what is really meant when we pass tax legislation here and how they can have some continuity in their planning. What does it mean when you change the at-risk rule? What will be the differences? What will the developers do different? Will it not be just big corporations and the very wealthy building the buildings?

Mr. **Williams**. That would be the tendency. I think the tendency of this bill on the whole would be to drive our business toward large financial institutions, many of who are tax exempt, by the way. And as you know, that is the pattern in England and Holland and other places where there are less tax aspects to real estate development. Second, others would find ways to give limited guaranties or some other way to structure a form of guaranty where you don't risk everything. You would slow the flow of capital from——

Senator **Bentsen**. You know, if you have a fellow who got a $20 million or $30 million—whatever it is—on his financial statement in the way of a liability, the next financial institution doesn't go back to see that that is backed by a 30-year lease from General Motors. They don't look beyond that normally.

Mr. **Williams**. That is right. I think you would see a slowing of the flow of individual capital into real estate because the individual would then have to be a general partner. If he is going to make a small investment in a real estate deal, he doesn't want to be exposed to the risk of the entire transaction. And incidentally, I think that is one other aspect of this bill, whether it is the limit on deductibility of interest or at risk. What has occurred since 1981? Now, this is the good part of the tax law change of 1981. The bad part, I would agree with you, is they went too far. We did not need 15-year depreciation and didn't ask for it, and it drove a lot of investments that were not sound——

Senator **Bentsen**. Let me tell you that some of your folks sure asked for it. I had a real hassle with them. I can remember. [Laughter.]

I can remember I won that vote on Friday, and on Saturday or Sunday they won it.

Mr. **Williams**. Yes, sir.

Senator **Bentsen**. And the next Monday morning, we were losing.

Mr. **Williams**. One of the good things that has happened since that bill is what we call in the industry "the securitization of the industry," and that is to say that small investors can now make real estate investments. Now, that wasn't true in the past. You had to be a wealthy person or a very risk-prone type of person, as maybe we are, to be in the business. But you now have securitization so that a small investor could own a piece of a real estate project, just as he could own a stock or a bond; and that was not possible, in the main, before that. Now, eliminating "at risk" is going to change that. What investor out there is going to be willing to be a general partner in a $50 million office building in Dallas, TX, for a $50,000 investment? So, you are going to stop the small investors from coming in. The limit on deductibility of interest does exactly the same thing. Who has investment income, this netting out requirement? Only rich people have investment income, that is, interest and dividends. If he can only deduct investment interest against investment income, it is only the rich people who are going to be able to invest in real estate. So, I think there are some unintended consequences that are adverse to the industry, and I would say, beyond that, to the economy that stop the small investor from investing in real estate deals. That is why maybe I am overstating it, but I say there is an anti-real estate bias.

The **Chairman**. Senator Long.

Senator **Long**. Mr. Cohen, I was trying to recall how long you served with the Government. When did you first go with the Government?

Mr. **Cohen**. I became Chief Counsel of the Revenue Service in December 1963, sir. I became Commissioner the next year, in December of 1964. I started service January 1965. That is 20 years ago.

Senator **Long**. Let's see. You became Commissioner when Lyndon Johnson was President?

Mr. **Cohen**. Yes, sir. That is right.

Senator **Long**. He had a very high regard for you. He recommended you very highly as I recall, partly on the basis of your collegiate record. I think you had an extremely high record, and you are not supposed to brag about it, but what was it? You had a very good record in college, did you not?

Mr. **Cohen**. Keep talking, sir. I like that. [Laughter.]

My mother would be happy to hear that.

Senator **Long**. I am trying to recall that. Where did you graduate from?

Mr. **Cohen**. I was around 36, and thought a young man ought to have the job.

Senator **Long**. Yes, sir. Anyway, now you were serving in Treasury about the time of Stan Surrey, and I think part of what you

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say sort of would be in agreement with Mr. Surrey. He was serving as——

Mr. COHEN. As Assistant Secretary for Tax Policy.

Senator LONG. Do you pretty well agree with the views he espoused during that period—during those years?

Mr. COHEN. Not entirely, but a great deal.

Senator LONG. He is a very brilliant man. It did confuse me, looking back on it. I admired Mr. Surrey in many respects and still do, but he came up to Capitol Hill, lobbying me and urging me to vote for the investment tax credit.

Mr. COHEN. I happened to oppose it, as you did at the time, sir.

Senator LONG. At that particular time, I didn't think it was a very good idea. And part of what I objected to about it was that we were going to let these people have a tax credit, and then that tax credit was for, say, 7 percent at the beginning, and then let them write off the full 100 percent. So, it seemed to me as though it made pretty good sense to let them have the seven percent, but I didn't think that they should be able to depreciate something they never paid for to begin with.

Mr. COHEN. You wanted a basis adjustment. I didn't want it at all but I lost that battle.

Senator LONG. I insisted and prevailed in the beginning that we have a basis adjustment. And after a while, I was presuaded, mainly by the administration, to relent on that over a period of years. But Mr. Surrey came up and made a strong argument in my office to me that I ought to be for that and that it would do a lot of good for the country. And then later on, I found out that he wasn't for it. So, he made a deal down there at the Treasury. [Laughter.]

Can you recall what it was that he was for, that he got in support of consideration for this investment tax credit?

Mr. COHEN. He was pushed into it by President Kennedy who was strongly convinced by some economists that this was the way to go. There were a number of tradeoffs, and I am not exactly sure—I don't recall right now—which were the issues he was for. But Stanley Surrey had the magnificent ability, once the decision was made, to declare victory and march on in front of the parade. In this instance, he did.

Senator LONG. He came to my office. He made a strong pitch for it and made the impression on me that there was a man who was sincerely trying to do something for the country. It turns out that he wasn't for this thing at all. He thought it was a lousy idea. [Laughter.]

And it violated all of his principles, yet there he was, seeking to sell me and other people on the Committee in supporting the thing. Now, I happen to think that, purely as a subsidy and nothing else, as a tax subsidy that it did a lot of good. Later on, I persuaded Lyndon Johnson—maybe while you were the Commissioner——

Mr. COHEN. Yes, we suspended it.

Senator LONG. To call it off because it was overheating the economy. It was not only stimulating growth; it was stimulating it too much. The interest rates were too high. And yet, it would seem to me that if you wanted to provide a subsidy to get things moving, measured against that time, that would be a classic example of where you did it. And my impression is, and just take that one thing, although we have done other things along that line, it was a better thing than to go by the appropriations route because anybody could read the rules, and with a good lawyer, he could follow the rules. If so, he would get the benefit of it; and the alternative would be to apply to some Government bureau for a permit and then, par for the course, if you go there the boss is out. They say he is on annual leave or something. Come back next month. And then you go back, and you get the application filed. It eventually goes from that office to some other office. And after a while, with the help of your friendly Congressman, you might try to get the thing approved. But it seems to me that it is so much better to do it the way we did it, if you are going to do it at all. That is, everybody gets the benefit of it. They can all claim it. And I just wonder if you are going to have a subsidy, and I am not embarrassed at all to call it that and accelerated depreciation subsidies because they are. If you are going have subsidies, shouldn't they really be considered based on which would be the best way to do it for the benefit of all concerned? Sometimes it might be done by appropriation. I am sure it would be many times, but other times, as in this case, I think it is better to do it by the tax law.

Mr. COHEN. The difficulty with doing it the way we did it is that, here, we have been doing it now for 20 years, on and off. It got built into the system. Economic forces didn't take effect. The marketplace didn't evaluate projects on their economic merit. It valued them on their tax merit. And therefore, we did things that were designed by this committee and the other committees that considered that bill at a static time. There was no reevaluation, periodically. You could design a subsidy program which would have no more supervision than the Intenal Revenue Code. You won't, but you could. You could provide it as an entitlement program. That is what we are fighting about right now in a variety of entitlement programs, that they are openended. So is this. It is an openended call on the Treasury.

The CHAIRMAN. By that, do you mean that there is no entitlement program if you want to invest $100,000 in a machine? You just come to the Government and say: "Give me $10,000."

Mr. COHEN. You show us the receipt for the machine, and we will give you $10,000. It is the same thing. That is exactly what you have done. You don't have to have any more supervision on one than the other.

The CHAIRMAN. I would wager that even that simple a system would be more expensive to the Government than using the Tax Code, by the time they got around to issuing the $10,000 check.

Mr. COHEN. I understand. You could provide for a deduction against the tax system. I wouldn't mind that. But one of the difficulties that you don't look at, and we are seeing that in the oversight committees right now, is that the revenue system is falling apart. The audit level is down to 1.2 percent. The collection problems are astronomical. The computer system is breaking down. They don't have enough personnel. There is a whole variety of things that are occurring which tell me that something has to stop. We can't keep putting more people in there, because you won't do that either. Therefore, we have to help administer a system that works.

The CHAIRMAN. Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman. As I listened to the statements and testimony of the witnesses, I am reminded once again of one concern that I have increasingly have about this proposal. In only one area of it, they have described a problem that is reflected in other areas, and that is that by extending depreciation and putting the windfall recapture or the depreciation penalty tax on real property, you create a huge problem in determining revenue neutrality because, basically, what is happening is you are accelerating near-term revenue which will take care of the problem for 4 or 5 years. Then, at the end of 5 years, it isn't there any more, and a tax increase or some other kind of excercise as we are doing now is going to have to take place. It strikes me that the deficit will probably be a continuing problem throughout that spectrum of this tax bill, and a genuine tax reform really ought to exchange permanent revenue losses with permanent revenue gains, and this is one area where it clearly does not do that. And it is going to have to be visited. I just make that observation. Then, as I listen, I have an overwhelming sense of panic, and I would just ask the table what market forces outside the Tax Code exist in real property construction, home ownership, or otherwise. Is there any marketplace out there that isn't taxdriven now?

Mr. WILLIAMS. May I comment on that?

Senator WALLOP. Anybody may.

Mr. WILLIAMS. This theme has occurred several times. From our observations in the commercial real estate development business, and this is true back from when our company started in the late 1940's until now, the tax aspects have not been the driving or main reason for any building we have ever built in the history of our company, which is about 12 or 14 billion dollars' worth of projects. So, I think the idea somehow that most of real estate is developed because of tax reasons is simply outside the marketplace.

Senator WALLOP. Mr. Williams, that flies in the face of the testimony from the table here that, if we do anything to these tax structures, the real estate business—commercial real estate, home ownership—is going to collapse. So, I mean, it either was a factor and perfectly legitimate—I am not complaining about its having been one; I don't complain about anybody having taken advantage of a Tax Code that was put there to create certain effects. And the fact that those effects were created is useful to us. But either you didn't have some look at those tax benefits or, if they weren't a factor in there, the loss of them would be of less consequence than the testimony at the table would indicate.

Mr. WILLIAMS. Yes, sir, but that would be true of any form of investment. If you quadruple the tax on the sale of stock, that would certainly have an effect on stock. Then, you could say that the real reason that people invested in stock was tax reasons. So, surely, taxes are a part of all of this; every form of investment considers that, but eventually debt has to be paid back. You have got to build a building with a view toward its income and not with a view toward its tax benefits. You eventually have to pay the debt back or you lose your whole investment. So, our business as developers is primarily to build buildings that we can rent and get income from in order to pay back the debt. Now, if you cannot finance out the entire project—and as you know, we are an industry primarily debt financed—then you have to bring in equity investors to make up the gap or lower your overall cost of funds in order to complete the project. But essentially, I think that most real estate developers in this country do not do business primarily because of the tax reasons. Surely, taxes are a part of your investment analysis, but they are of every form of investment analysis as well. Now, housing might be different on that.

Mr. **Koelemij**. Senator, may I comment? You know, the market forces are that the baby boom results are going into the marketplace; there has been a migration from the North to the South and to the West; and the Tax Code really is only one aspect of what is going on. Now, I agree with you that the effects of the Tax Code have had a tremendous impact on, and encouragement of, home ownership. We are the best housed country in the world. There is no country anywhere that can outshine us in that, and I am sure that the deductibility of interest has had a great influence on that. While many tax incentives would be removed, the mortgage interest deduction is retained because to recall it would affect home ownership, which I think is basic to this country.

Senator **Wallop**. Mr. Chairman, I am not quarreling with any of that, and I am not asking anyone about the benefits we have had. I am just not certain of what the real marketplaces are. And I just want to say to Mr. Williams that that has not been my business, but it has been some of my investments over the course of time, particularly in the San Francisco area. And I can guarantee you that it was a high consideration of mine and a very useful one. It was a perfectly legitimate one, but it was necessarily—aside from the fact that it was a plausible deal in the long run, what made it shine over other investments that were open to me at the same moment in time was clearly the Tax Code.

The **Chairman**. It was clearly what?

Senator **Wallop**. Clearly the Tax Code. I mean, I had options as to where to place investment capital that I had, all of which had relative degrees of promise; none of which had the relative degree of immediate promise that the commercial real estate development of office parks in the San Francisco area could offer me. You know, I have no hint of conscience about having exercised it. It was a very useful investment, but it still was necessarily the principal driving force, given 2 otherwise equal long-term performances. The principal reason I went with it was the short-term performance of the Tax Code.

The **Chairman**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman. And gentlemen, thank all of you for your testimony here this morning. I want to ask a question aimed at predictability. One of my big concerns is that about every 2 years, since 1976, there has been a change in the Tax Code. And it just seems like to me—and I think I was the one who said here when we started the first round of hearings that probably the greatest reform we could do for the American taxpayer would be to adjourn this committee for about 10 years and let people find out what we have already done in the last 10 years——[Laughter.]

Because it started in 1976, 1978, 1981, 1982, and 1984, and now we are here in 1985. If this were a true flat tax and took out the bias of the Tax Code against savings by something on the order of the Hall-Rabushka plan, or based on that, then I think I could get very enthused about it. But let's just say, for example, that we come up in this committee—we work through this proposition—and come up with something close to what the President has sent over here as a final product. I want to ask you two questions. The first question is: How long of a transition period should there be between where we are now and going into the new system? And second: Would it be better once we have achieved the goal—and let's say you have a top rate of 30 percent or 35 percent and different deductions that are now in preferences or are now in the code are removed—that we just set this thing on a 10-year program and say that, on the basis of 10 years, it is going to change by 10 percent a year until we get there, so you don't have a big location. So, I want to ask first: How long a transition period should we have to allow taxpayers to elect to go under the old system in a transition to a new one? Or second: Would it be better to have a 10-year fit, that this just changes 10 percent a year until you get to where you are going? Let's just start down there at the end, and you can move right up the table.

Mr. McDaniel. I think you have to go on an item-by-item basis, Senator. I don't think you can adopt a flat rule that says 10 years is the right number for commercial real estate, and it is also the right number for low-income housing, and it is also the right number for machines and equipment. But you are clearly right that, as you are reducing subsidies run through the tax system, you have got to have an appropriate transition rule. But I do think the time period will vary and the methodology will vary from special provision to special provision.

Mr. Cohen. The difficulty with the current package that was sent up here is that it has no transition rules, the transition rules it contains are draconian. Most of these provisions, if you were to follow the President's recommendations, become effective January 1—boom—with no binding contracts rules or no other rules that would allow for the dislocations that always occur. And that is one of the black holes in this thing. I don't know—it has a cost of $10 or $11 billion—some people have said $8. I have seen many numbers thrown out. You need transition rules, both for equity in terms of this committee and the Ways and Means Committee's traditional mode of operation. You also need it in terms of business adjustment, as you have pointed out. That is, to let the market forces gradually take hold, because we have had an industry or groups of industries, not only in this area but other areas. Wherever you are going to make dramatic changes, it is better to make them gradually than it is to, you know, just take a right-hand turn, because taking a right-hand turn is very sharp, and it does cause a lot of dislocation.

Senator Symms. Move right along down the table. I am running out of time here.

Mr. Koelemij. Senator, some of the provisions in the proposal are just not fair and would not be cured by any transition period because there would be some discrimination. There is no economic neutrality in some of the aspects of the proposal. For example, low income housing would not be helped by a 10-year transition period unless we come up with some direct spending programs to take care of that issue. However, if you make long-term changes, you need some substantial transition periods because investments in real estate are not financed on a short-term basis.

Senator SYMMS. Right on that line, on low-income housing, are you fairly confident the rents will go up if this bill passes in its current form?

Mr. KOELEMIJ. I can guarantee you. Besides that——

Senator SYMMS. How much approximately?

Mr. KOELEMIJ. It is our estimate that rents will go up anywhere from 21 to 28 percent, as reflected in our testimony. I believe tax-exempt bond financed housing will go up anywhere from 38 to 45 percent if you remove the use of industrial development bonds. The existing stock of subsidized housing units will suffer the most, I think, and I have stated that to the Secretary of Housing and Urban Development. He will become the greatest owner of subsidized rental units because they will be returned to him.

Senator SYMMS. I am out of my time, but if you could answer very briefly, Mr. Williams.

Mr. WILLIAMS. I will make it very brief. On the transition rules, I think again we could go to some period of phase-in, but second, let's don't retroactively affect existing deals. Let existing deals stand. Don't go back on investments that were made based on certain rules and then change the rules. On the phase-in, our industry can adjust to anything over a period of time. Now, this is because there is a basic demand out there for real estate. This is not an industry created by the tax laws, and somehow I think that is an idea that is around here. And that is wrong. There is a fundamental demand side here. Now, what I think this bill does, though, is it is going to shift the industry away from private, entrepreneurial, aggressive, local, regional people to institutions. So, yes, the industry can adjust, but it is going to be different folks. And it is going to be big institutions that are going to be doing it and not individuals and local and regional.

Mr. MOORE. Let me just make a comment, Senator. I think definitely a phase-in should happen, but I agree with Don, that we should leave well enough alone with those that have invested now and start it after that. But my main concern in this whole thing is that we should really encourage small investors to invest in real estate and particularly home ownership. And when we have a tax reform bill that is going to make it more costly to own homes, then I think we are just going against the whole thrust of the United States. And what is really going to happen is that we are not going to have people, when they retire at age 65, able to have an equity in many cases on which to retire, and we are going to have to take care of them in their elderly years. And it seems to me that we are going away completely from that concept. And on the other hand, we are not doing anything to balance the budget or cure the budget deficit problem, which is really something that bothers me on this whole reform bill.

Senator SYMMS. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman, and I thank the panel for their testimony. I think it is to the point, and I think that it is very helpful. I have been intrigued by this side of the panel talking about what drives real estate investment and the fact that it is market opportunity, laws of supply and demand, migration patterns—all of those aspects of economic life apply very directly to the real estate industry as well as many other industries—and that a component, and I would guess from the testimony, a small but significant component is the tax system itself. Last year in this commitee, Senator Dole proposed that we not have the industry even worry about taxes; let's just exempt the real estate industry from taxes. Would you be supportive of that?

Mr. **Koelemij**. No, Senator, I would not be.

Senator **Bradley**. Why?

Mr. **Koelemij**. Because everybody should pay a fair share of taxes.

Senator **Bradley**. Would you be supportive of that?

Mr. **Williams**. I would have the same opionion as Mr. Koelemij. I don't know, if you look at the industry as a whole now, what its net tax position is, and certainly it is favored. That might be simpler.

Senator **Bradley**. All right. Mr. Moore.

Mr. **Moore**. That is a difficult question to answer, but I think you would have to look at the revenue side of it. Would it some way, somehow bring the revenue side up, which has got to happen some way, somehow? On the surface, no. I don't think it would fit either way because everybody should pay their fare share.

Senator **Bradley**. Prior testimony has been that if we simply exempted the real estate industry from tax, the Federal Government would have about $10 billion more in revenue. That gives you an idea of the size of the subsidy that exists in the Tax Code today. So, you wouldn't have to pay any taxes, but you also wouldn't get any subsidies from the Federal Government. Does that make any sense to you, Mr. Cohen?

Mr. **Cohen**. No, of course it doesn't. In a typical real estate transaction where I see in a 2-for-1 deal in the first 5 years, and those are not unusual, you actually are putting up no cash. Federal is tax-free. You put in the money and you get it back through the tax system. In a 2½-to-1 deal, you are ahead. It is hard to get much above that. I would agree with Mr. Williams that, certainly when I advise an investor, I advise an investor to look for a solid piece of real estate to go along with tax attributes. That doesn't mean that the marketplace is operating that way. It isn't. The marketplace is operating as much in a tax selling deal as it is in a real estate selling deal, at least the part of the marketplace that I look at quite often.

Senator **Bradley**. So, would you be supportive of exempting the real estate industry?

Mr. **Cohen**. It would be cheaper.

Mr. **McDaniel**. Senator, I think what the Joint Committee staff is telling you is that, if all the subsidies for real estate were converted to direct subsidies and the industry paid taxes based on economic income, the amount of the subsidies are $10 billion more than the taxes that would be paid. Having said that, you are told something about the subsidies, but it doesn't tell you whether the industry ought to pay taxes or not. I would suggest that what real estate ought to do is pay taxes and then we will decide the level of subsidies as a separate and independent matter. Whether that is more or less than the taxes they pay is a judgment about subsidy levels; it is not about its tax system.

Senator **Bradley**. Let me ask the three panelists at the end: Do you think that if the Administration's bill was adopted that you would see an increase in real estate investment trusts? Take into consideration the fact that the at-risk rule would be eliminated but it doesn't apply to the real estate investment trust.

Mr. **Williams**. I think the short answer is yes. That is already occurring, by the way, and part of it is due to the uncertainty over the tax laws at the moment, as well as this whole shift toward an orientation to income in real estate. So, I think the short answer is yes, and it is already underway.

Senator **Bradley**. Could you share with us why that shift has taken place?

Mr. **Williams**. The shift is taking place today because of several reasons. One is accessing public capital for real estate markets, whether it is small, medium size or large investors. We are a capital-intensive business. We are an enormous user of capital, and that is simply an evolution that is occurring—of accessing public capital, and real estate investment trusts are a very good way to do that. Secondly, because of their flow-through tax treatment, there are essentially tax deals where there are deductions in excess of money invested, and they have already gone out the window. What you all did in 1984 essentially cured most of that. So, most real estate investments today are being done primarily from an income standpoint, not tax standpoint, anyway, and the REIT is a good form of vehicle to do that. So, you both access the public and you get to the income orientation, which I think the industry is moving towards, anyway.

Senator **Bradley**. Could I ask one more question? A consistent theme here, and I find it very interesting, is that if we went with something like the President's bill, you would see a change in the financial sources for the real estate industry, and it would be much less individual and would be much less small investor. It would become big and institutional. HUD has a study that says 60 percent of all rental buildings of one to four units, and 80 percent of all tenants live in buildings of fewer than 20 apartments. Now, a lot of these are owned not by companies but by "mom-and-pop" operations. Also, a lot of these don't know anything about the Tax Code. They don't take accelerated depreciation. My question to you is: What kind of information can you provide for the committee to demonstrate that, under the present tax system, you do find a lot of small individuals utilizing the tax system in order to produce low income or other housing and that, absent that tax subsidy, wouldn't be built? My impression is that the mom-and-pop operation on the corner that has two apartments above the store that they rent out, they don't depreciate that. Sixty percent of all the apartments are in that one-to-four apartment dwelling level. So, how can we get a fix on what numbers are? Any panel member?

Mr. **Koelemij**. I would like to answer that. I am a homebuilder. I own rental properties, some of which are duplexes, quadriplexes, and some which are FHA subsidized projects that we built in the early 1970's. I will try to get you the information that the number of 60 percent is incorrect. What I mean to say is this: I know from our type of activity, we might build a group of quadriplex buildings which are subject to an individual permit that is then syndicated and small parts are sold to investors. Now, that then relates to the individually built and constructed quadriplex, but it is put together in a limited partnership; and we have 60 units in one limited partnership. I guarantee you that the tax incentive goes with that. And I also want to add that that tax incentive or benefit is ultimately reflected in the rents that we have to charge, and the removal of some of those incentives will raise those rents. There is no question about it. I will try to get that information to you to see what of that 60 percent is really owned by larger owners than the individual mom-and-pop operations.

Senator **Bradley**. The more information we can have, the better.

Mr. **Koelemij**. Yes.

[The information from Mr. Koelemij follows:]

National Association of Home Builders
15th and M Streets, N.W., Washington, D.C. 20005
Telex 89-2600 (202) 822-0400 (800) 368-5242

John J. Koelemij
1985 President

August 7, 1985

Honorable Bill Bradley
United States Senate
Washington, D.C. 20510

Dear Senator Bradley:

At the Finance Committee hearing on July 16 you noted that 60% of rental units are in 1 to 4 unit structures and that 80% are in structures of 20 or fewer units, and you suggested that this indicates that much of the rental housing stock consists of "Mom and Pop" operations which are not sensitive to tax provisions. I promised to provide further information on that subject.

As I noted in response to your question, many large-scale rental properties consist of numerous structures with individual structures often containing four units or less. This is confirmed by the Census Bureau's report on Residential Finance, which showed that most rental properties with 50 or more units consisted of multiple structures, with about 40% of such properties having 5 or more buildings. However, it is also true that a substantial share of rental housing is in "Mom and Pop" arrangements where the owners have modest incomes and are not real estate professionals.

These small operations were once the dominant source of rental housing, but they are now something of an anachronism. Most such properties were built before World War II, and many of the current owners received the properties through inheritance.

In about half of the 2 to 4 unit properties containing rental units, the owner is an occupant as well. A study in Massachusetts showed that a large percentage of the tenants are relatives of the owners. There is little turnover among tenants in such units. As a result, few of these units are available to people in search of rental housing.

As in any competitive market, rents are determined by the cost of providing additional or "marginal" units, although the nature of the housing market is such that it may take several years for rents to adjust to changes in the costs of providing additional rental housing. New additions to the supply of rental housing consist overwhelmingly of larger, professionally-managed properties. The amount of new construction of rental housing is very sensitive to changes in the tax treatment of investors and to the availability of tax-exempt financing.

As we stated in our testimony, the immediate effect of tax reform would not be higher rents, but a cutback in new production. Over time, the lack of new construction and of rehabilitation of the existing stock will cause tighter markets and higher rents. Although the full impact on rents will be evident only after a substantial time lag, rent increases in the short run would still be sufficient to offset any benefit of tax reform for low- and moderate-income renters.

Economic logic, the empirical evidence, and the overwhelming consensus of expert opinion all suggest that the elimination of tax preferences for rental housing will rebound to the detriment of renters. Most renter households have low or moderate incomes (the median income of renter households is only about half of the median for homeowners and fully 27% of renter households are below the official poverty line). Rent already accounts for a disproportionate share of the budgets of those households. It could be -- and has been -- argued that the tax system is not the appropriate vehicle for assisting renters, but there is no realistic alternative available at this time and it would be callous to withdraw this assistance under the guise of achieving "economic neutrality". Moreover, the experience of the past two decades provides little support for the idea that direct expenditures are a more efficient or effective mechanism than tax incentives for meeting housing needs.

We would be happy to provide additional information to you or your staff on this or other housing issues.

Sincerely,

John J. Koelemij

John J. Koelemij
President

The **Chairman**. Senator Grassley.

Senator **Grassley**. Mr. Chairman, I am going to momentarily pass.

The **Chairman**. Senator Heinz.

Senator **Heinz**. I feel that I should follow Senator Bradley's lead, Mr. Chairman, since I just walked in. I want to apologize to our witnesses for being late, but a number of us were meeting with our House colleagues on a subject that is even more important than tax reform; namely, the budget. And I have nothing to report, but hope springs eternal. I want to observe that the issues that are the subject of this hearing today are of particular importance to me, not just as a member of this committee but as a member of the Banking, Housing, and Urban Affairs Committee. We have, for a number of years, relied upon the incentives, the subsidies in the Tax Code to help us with provision of housing, which the middle name of the Banking, Housing and Urban Affairs Committee. The cutbacks in Federal funding for housing, of course, have been very substantial. We don't have any new section 8 program any more. We have some rehab and some existing section 8. No one contends, for the moment, that we are staying even with respect to low and moderate income housing production or provision. And of course, the President's proposal could have a major effect on rental housing production, particularly in low-income rental housing. And for the first time, the President's plan eliminates all distinctions between rental housing and commercial buildings, and further, it eliminates any distinction between low-income housing and other housing. And that is of great concern to me because we need to be sure that, after the cutbacks we have done in Federal spending programs on the production of low-income housing and housing generally, that we don't end up really calling a halt to that kind of housing. The other observation, Mr. Chairman, I want to make is that with respect to the third part of the title of the committee—Banking, Housing, and Urban Affairs—namely, urban affairs, we have not exactly been moving in with larger and larger Federal support mechanisms for our cities. We have been cutting back on urban development action grants, mass transit, community development, block grants, and so forth, but the one reason, I think, that so many of our cities have been able to continue to improve their core areas has been the tremendous success of the historic rehabilitation tax credit. Now, when I met with the Pennsylvania president of the Mayors' Association—a Republican—a miracle—from York, PA, he did his usual lobbying on behalf of the State and local tax deduction and its present ration. But what he said was that: Senator, the one thing that really is working—you know, you have in the Federal Government all this redtape—if there is one thing you really have to preserve above all—whether it is going to help Philadelphia or York or Pittsburgh or Scranton or Erie or Johnstown or Altoona—it is the historic rehabilitation tax credit. That, he said, is our urban policy. Now, a question: Do you agree or disagree with that assessment? Anybody? Mr. Moore?

Mr. **Moore**. I think most of us in the real estate industry would agree wholeheartedly with that because rents are going to have to go up in order to get a reasonable yield in return. If you don't have some of these incentives for rehab or low income-housing, then what we are going to have is, No. 1, is probably a lesser supply which is going to cause a higher demand, and fewer people are going to be willing to take the risk without these rents going remarkably higher.

Senator **Heinz**. Let me ask this question. It is maintained and perhaps by some of you—I didn't hear your testimony earlier—that in a sense it is not the end of the world to reduce all the tax breaks of commercial property. Maybe it is for Don Williams. I don't know. But at least with commercial properties, you can argue that the users of commercial properties tend to be fairly well-heeled organizations, corporations, from General Motors on down, whereas the user of low-income housing or just plain rental housing is not in the same financial class at all. And that is an argument, of course, for maintaining a distinction between the treatment of commercial properties and housing rental properties. My question is: Would anyone argue against retaining a distinction based on that? Dr. McDaniel, could you talk to that?

Mr. **McDaniel**. I think the question really is: Could you design a program that is more efficient and doesn't cost the Federal Government so much money for the amount of housing we are getting?

Senator **Heinz**. I assume we are smart enough to do that.

Mr. **McDaniel**. Yes, I think you are.

Senator **Heinz**. I don't want to put that to a vote. [Laughter.]

My time has expired.

Senator **Grassley**. Mr. Chairman.

The **Chairman**. Senator Grassley.

Senator **Grassley**. Mr. Cohen, you devote quite a bit of time in your statement to tax shelters, and I don't think you answered something that has been of interest to me. And that is, assuming the President's proposal would be passed as is—and of course, it won't—but let's assume that it would be, do you think that it would have a damning impact upon the business of tax shelters—of selling tax shelters and putting together tax shelters?

Mr. **Cohen**. For about 15 minutes. We can figure out other ways.

Senator **Grassley**. So, in other words, it would not have?

Mr. **Cohen**. Yes; any economic judgment, and I think it has been raised before, is an after-tax judgment. Any businessman who goes into a transaction—or an investor—looks at the after-tax yield. And the depreciation, even after the President's proposal, is not bad. It will adjust rates. It will adjust prices, but the marketplace will adjust to that; and I believe investors will adjust very rapidly and will see that good real estate, as has been described here by Mr. Williams and others, is still a good investment, taking into account its tax attributes and will continue to invest.

Senator **Grassley**. Then, you have not seen a parallel reduction in tax shelter business with the reduction of the marginal tax rate?

Mr. **Cohen**. That is strange. Everybody predicted that there would be less tax shelters when we went from a 70-percent rate to a 50-percent rate; instead, it went the other way. There was a proliferation. What had happened is that it had become popularized; and once it became popularized, then it was only a question of pricing it and making it attractive in the marketplace. And it was slightly less attractive, but it was more popular, and therefore, it was bought in greater amounts. And I suspect that the numbers are larger in terms of—and I am talking about tax shelters in their better sense. That is, something that has economic viability to it and not the fly-by-night mineral shelters and some of the others that were almost frauds from the beginning.

Senator Grassley. My second question would be both to you and to Dr. McDaniel. What is your response to the assertion on the part of realtors and home builders and builders generally that rents are going to rise as a result of this tax bill passage and the extention of ACRS and other things that encourage the investment in rental property?

Mr. McDaniel. I think that is a likely response, and it will vary across different types of real estate. The President's proposals are based on the fundamental proposition that rents should rise to the market level and should not be kept artificially low by means of subsidies, whether tax or direct. So, the question really is: Does the committee and the Congress want to continue subsidizing lower than market rentals through the tax system for all kinds of real estate?

Senator Grassley. Mr. Cohen.

Mr. Cohen. It will take a while. I suspect that, if this were to be enacted on, let's say, January 1, 1986—which I suspect it won't, but if it were to be—you won't see any effect immediately, because there are market forces out there and there is so much housing. As time goes on, yes, it will have an effect because there will be less housing.

Senator Grassley. Would you generally feel that the 28 percent—I think I heard that in previous testimony—that rents might rise as being in the ballpark?

Mr. Cohen. Not being an economist and not having gone through the studies, I can't say. I do know that it would go up. I can't predict how much.

Senator Grassley. Dr. McDaniel.

Mr. McDaniel. I haven't see the assumptions that are cranked into those estimates, so I wouldn't be able to comment.

Senator Grassley. Thank you, Mr. Chairman.

The Chairman. Mr. Koelemij, I think there is going to be a tax bill, and possibly this year if we get it in time from the House. Most people say they will not vote for a tax bill that loses money. They want at least a revenue-neutral tax bill. Now, after we have passed it, 3 or 4 years down the road, some of our assumptions may not pan out; but at the start, we want a revenue-neutral tax bill. Assuming that, I am going to go down the list of things that the NAHB opposes, and ask you what to do to make up the difference. You are opposed to the elimination of deductibility of State and local taxes, to the limitation on deductibility of nonbusiness interest, to the elimination of mortgage revenue bond financing, to the curtailment of the use of builder bonds, to the longer depreciation period for buildings, to the elimination of capital gains treatment on the sale of buildings used in trade or business, to the elimination of tax-exempt financing for multihousing construction, the elimination of the 5-year writeoff of rehabilitation expenses for low income housing, to the repeal of the rehabilitation tax credit, to the extension of at-risk rules to real estate, to the windfall recapture tax, and to the repeal of special rules to deduct construction period interest. I had not made notations alongside that list, but my guess is that is about three quarters of the revenue in the bill. If we adopt all that you suggest and we want a revenue-neutral bill, what should we do to make up the difference?

Mr. KOELEMIJ. Senator, the question first arises: Do we need a bill? [Laughter.]

I had to say that.

The CHAIRMAN. All right, but we have a bill.

Mr. KOELEMIJ. As I said before: If it ain't broke, don't fix it. But in the revenue estimates that we have looked at, we expect that we first have an obligation to bring to your attention the effect that this proposal has on housing and our ability to house people in this country. That is an obligation we have. So, when you gentlemen start the markup of the proposal, we hope to be able to submit to you, and to be reacted to, what we feel is absolutely necessary. In our deliberations of these items, which we are doing right now—we are meeting in Wisconsin, and I came up to testify before this committee because I think it is very important—we will look at some alternatives. For example IDB's maybe limited to housing only, or targeted better. Also, the question arises: Do we have to give all the benefits that are in this proposal, that is, do we have to go to a $2,000 exemption, which is one of the main big costs of this proposal? Do the people of this country really expect to get the $2,000 deduction, since they are going to have to pay for it in higher rents or housing costs?

The CHAIRMAN. At the moment, though, you have no suggestions as to revenue?

Mr. KOELEMIJ. Not at the moment, Mr. Chairman.

The CHAIRMAN. All right. Now, among this list that I have read—and I do think there will be a bill—and my hunch is you won't get all of these. Can you put them in some priority order as to which are the most valuable to you?

Mr. KOELEMIJ. It would be presumptuous of me at this time, but I can tell you this. Some of the items that deal with the ownership of real estate that affect rents are very important. The other two items deal with the removal of the installment sales treatement of homeowner bonds and the removal of mortgage revenue bonds which was recently reauthorized. This seriously affects the ability of first-time young families to become homeowners, and we would try to hang onto those as ones that we need, or that the country needs. We will be able to bring you some more alternatives or compromises, if you might call it that, but I think it was our purpose with this analysis to show you on a broad basis how it affects real estate, that it is not all beneficial.

The CHAIRMAN. Mr. Williams, as to commercial real estate, and I think you hear me talk to the National Realty Committee, and I think you heard Senator Long or Senator Bentsen or somebody else ask if we have made things too rich for commercial real estate in the past; and I used the expression that there is a certain feeling on the committee that it "didn't move," and it is not faced with Japanese competition yet. And maybe there is a way to do it, but they haven't been able to bring over 40-story prefabricated buildings and set them up. [Laughter.]

What would happen to the commercial real estate industry if they lost most of the present tax preferences? If you lost at risk and if you have a useful life depreciation, and there was no encouragement to build them except as to a straight economic encouragement? You would have none of Malcolm Wallop's investments in real estate because he thought it was a better tax preference than other alternatives at the time? Would commercial buildings still be built as needed?

Mr. **Williams**. They will be built, Mr. Chairman, because the market demand is out there. Somebody will build them. I think what you will have is what I described earlier as the pattern of England where, because you have no depreciation, most of the commercial real estate in England is owned by tax-exempt organizations, very large pension funds. So, you have a nondynamic market. You have it noncompetitive. You have very high rents. You are probably familiar with the rents in London and other places in England; and of course, they also have a high degree of regulation there. So, you will have an industry. It will be, in my view, substantially smaller. It will be dominated by a very few, large, tax-exempt organizations because a pension fund doesn't pay tax, anyway, so it doesn't matter to them. I think that would be the consequence of an extension of this type of an approach to real estate.

The **Chairman**. Senator Long.

Senator **Long**. I want Dr. McDaniel to give us a little more detail on what he had in mind when he said that the indexation will lead to tax shelters. Could you give us a concrete example, if you have one in mind, of how that can lead to a new tax shelter or shelters?

Mr. **McDaniel**. Yes, Senator. Let me start with just a quick example involving vacant real estate, but the principle is the same. Suppose that you invested $100 in a piece of real estate and held it for a year, during which time the rate of inflation is 10 percent. You borrowed $100 to buy that piece of real estate at an interest rate of 10 percent. You sell it at the end of year one for $110. You are allowed to index the basis on the asset side, so you will have no gain or loss, on the debt side of the transaction, however, you will still be able to deduct the full 10 percent of interest. Therefore, in a transaction in which there is no economic gain or loss on either the debt or the asset side of the transaction, the taxpayer is going to walk away with $5 from the Treasury Department. Now, the principle is exactly the same when the asset that you are buying is a pot of real estate deductions instead of a vacant piece of real estate. The mathematics are a little different, but the principle remains the same. So, actually, you are going to make the tax shelter richer if you index one side but not the other of the transaction than it is today.

Mr. **Cohen**. And you will encourage more heavily debt financial investment, which makes everything more risky at the same time.

Senator **Long**. All right. Thanks very much.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman. Not so long ago, I was in a conversation with a major figure in monetary policy, and he offered the view that he had just come back from California and he couldn't get over the fact that there were still banks out there

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that were loaning sizable sums of money for redundant real estate investments. And they were loaning the money with the understanding that, even if they rented up to 95 percent immediately, they would never really be able to repay that debt. This individual went on to speculate that the only thing that was going to get this kind of speculative binge of loans out of the system was tax reform, essentially taking away the subsidies and thereby shaking the bankers to the point where they again decided to make loans, not on the basis of speculation, but on the basis of real value. And I point to a New York Times article here, not so long ago, that says: "Building Boom in Los Angeles. Glut causes lowest rents in six years." Or in the Wall Street Journal: "Office Glut is Bonanza for Tenants as Landlords Cut Rents and Add Perks." My comment to you is in these deals, you have sucked in the whole banking system. So, there is a lot at stake here. What do you have to say to us about that?

Mr. **Williams**. May I just take Dallas as a case in point, Senator Bradley, because we have an overbuilding situation in Dallas. Ironically, on the other hand, we are going to have net absorption in Dallas this year of plus or minus 9.5 million square feet of office space. That is net absorption. So, the business is expanding. We have a healthy economy out there, and the demand for real estate is very strong. So, that is one factor. Second, we do have overbuilding, but it is difficult to generalize about it. Let's just take Dallas. Dallas is a series of probably 15, and let's say 5 or 6 major submarkets. Several of those submarkets, such as Oak Lawn, at the moment are seriously overbuilt. Others are very healthy and are absorbing space on a very healthy basis. So, you have some kind of good new and bad news in this situation. So, there is still net demand for good quality, well sponsored real estate today. We are having, in fact, a record year in leasing in our company this year. Now, we are not proud of the rents on all of these things, I will admit to that quickly. Second, banks have already slowed the flow of credit into real estate. This overbuilding problem is well perceived, and I think that that has already occurred. The reregulation of the Thrifts is, I think, the most important factor in slowing the flow of unneeded, if you will, capital into real estate. So, I think to some extent that is true, but only partially true, and the problem is already being dealt with, and the answer to it is not in the tax laws. I repeat that I really don't believe that the building—we will start $2 billion of new buildings in the United States this year, and we are not starting them because of the tax laws. And if we have a problem in those buildings, we are going to have to write checks. We are not going to be bailed out by tax investors. Now, admittedly, that was true in 1982, due to the 1981 Act, but the 1984 act took those excesses out to the point that you don't have a deep shelter industry for real estate today that is bailing out poor projects. Investments are being made today on income and not on tax shelters. I think we are fighting a ghost of the past on this.

Senator **Bradley**. So, your point is that this excessively generous loan policy has been corrected?

Mr. **Williams**. Yes, sir.

Senator **Bradley**. And is in the process of being corrected?

Mr. **Williams**. Yes, sir.

Senator **Bradley**. Let me ask you this. Do you see any tension—and you had a long list that Senator Packwood read, a long list of things that you don't want to see eliminated—do you see any tension between what we call the gentrification tax subsidy, which is the rehab credit, and the low income housing subsidy? I mean, there is only a certain amount of capital. Is your downtown area going to be for Yuppies, or are you going to have low income Americans taken care of? You have a certain choice there. Would you admit that there is a tension?

Mr. **Koelemij**. Well, yes, there is, Senator, and I think that the remodelling of downtown would not directly always benefit low-income people because mostly it starts with buildings that will house offices. Where businesses have the courage to go into a delapidated downtown area to start to rejuvenate the community and to come back, residences will then be rehabilitated or people will be safe to come back to rehabilitated downtown areas. So, there is some competition and some preference in one direction, which would be toward the commercial use of those properties to a great extent.

The **Chairman**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman. I might just inquire of the Chair before I start any questions here that I see it is 11:15, and we still have another panel. Is that to go on yet this morning?

The **Chairman**. We will go on this morning, and we will go right on through the noon hour if we must.

Senator **Symms**. I find this a very fascinating panel, but I think I will withhold my questions and, maybe if I need to, submit some for the record so we can move onto the next panel. I know I have another meeting at 11:30, and I wanted to hear what some of the rest of them have to say.

The **Chairman**. Senator Grassley.

Senator **Grassley**. No questions, Mr. Chairman.

The **Chairman**. Senator Heinz.

Senator **Heinz**. One question, Mr. Chairman. I think I will direct this question to Mr. Koelemij. No, I am sorry. I think I ought to direct it to Bill Moore. Don Williams, in his testimony as I understand it, suggested depreciable schedules provide basic adjustments for inflation and fairly reflect the expected life of current construction in the relative lives of the various categories of depreciable assets, which is moving toward what the President has proposed. Do you support Mr. Williams on that particular approach?

Mr. **Moore**. On increasing the depreciable life? Is that your question?

Senator **Heinz**. It has to do with both adjusting the basis for inflation and presumably what would amount to a net stretch-out of depreciable lives based on real lives.

Mr. **Moore**. I think our industry could support a stretch-out of depreciable life. Our analysis indicates that adjusting the basis for inflation and then taxing the excess at ordinary rates on a good investment is certainly a deterrent to building and owning office buildings or investment real estate.

Senator **Heinz**. Let's focus on the second part, and everybody would like to have their basis increased for inflation. Let's be sure we understand what we are talking about in terms of the basis of

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expected life for current construction and the relative lives of the various categories of depreciable assets. What we are talking about is depreciation in effect based—somehow and I am not sure how easy this is to do—on an estimate of the physical life of these assets, if I understand Mr. Williams' proposal. Now, that could, instead of having an 18-year life for a structure, be a 40-year life, if that is the entire arrangement including the depreciable, or the step up in basis, and you could live with that?

Mr. **Moore**. I don't now that I would want to live with 40 years. I think I would go along, and I think our industry would go along with some adjustment like that, bottom-lining the whole thing. I think we would want to see by doing that that we are in effect going to solve what we think is a huge problem in the Federal deficit. Nobody seems to be talking about that much, in shifting this, but you know, if we are going to shift it and we are going to change, I think our industry—those of us in real estate—stand ready, willing, and able to do it—at least stand our fair share of it. Just to do it and have nothing happen to the Federal deficit doesn't make a whole lot of sense to me.

Senator **Heinz**. Well, that is another committee. [Laughter.]

I am just kidding. Thank you, Mr. Chairman.

The **Chairman**. Senator Chafee.

Senator **Chafee**. No questions, Mr. Chairman.

The **Chairman**. Gentlemen, thank you very much. Now, let's move on to a panel of Joseph Shepard, Barry Zigas, Allen Cymrot, Lee Henkel, Sally Oldham, and Michael Liberty. I would like to ask those who are leaving to move out quickly, please, so that we can start this panel right away. If you are done, if you could move out into the hallway and close the door, we would appreciate it. Lewis Payne will be testifying in place of Lee Henkel. And we will take the panel in the order they appear, and we will take Mr. Shepard first. As I told the previous witnesses, your statements in their entirety will be in the record. If you would hold your comments to 5 minutes, we would appreciate it. You can see how long we go with questions anyway, even when they are held to that length. Mr. Shepard.

STATEMENT OF JOSEPH A. SHEPARD, PRESIDENT, COUNCIL FOR RURAL HOUSING AND DEVELOPMENT, WEBSTER GROVES, MO

Mr. **Shepard**. Thank you, Senator. My name is Joseph Shepard, and I am chairman of The Lockwood Group in Webster Groves, MO. I am also president of the Council for Rural Housing and Development, on whose behalf I am testifying today. The council is composed of over 150 organizations who develop and finance low income family and elderly rental housing in rural America under the section 515 program, administered by the Farmers Home Administration. We appreciate very much this opportunity to suggest to the committee changes to the administration's tax proposal that are essential if such housing is to continue to be built in this country. What I would like to do, rather than spend my allotted 5 minutes with specifics on the changes we would like to recommend, is basically make a few comments regarding the importance of these changes to low income and elderly housing.

The **Chairman**. That would be fine.

Mr. **Shepard**. Congress acted purposefully and knowingly in making these various incentives available, realizing that, without them, very little such housing would be built. Basically, there are only three incentives that attract anyone to develop real estate. They are cash-flow, the possibility of appreciation, and thirdly, potential income tax benefits. In the case of low-income rental housing, the first two elements are missing. Generally, under Federal or State housing assistance statutes, the cash flow is limited to a very low percentage of return on investment. In addition to tight restraints on return on investment, the Government also controls the rents of any given development. Furthermore, with low-income tenants, there is a practical market limit on what rents can be charged. Generally, rental projects for low-income families and elderly do not show significant appreciation in the market. With a Government guaranteed or subsidized mortgage comes tight rent control and cash disbursement control. Even if these Government controls were to be lifted, many of these developments still would not experience substantial appreciation because small room sizes and lack of amenities make such projects unable to compete at competitive market rent levels. In addition, they are very low on the target list for possible condominium conversion. In any event, such conversions are precluded by a generally applicable requirement that locks in such housing for rentals for a 20-year period. Thus, absent very unusual circumstances, the chance for appreciation is just not there. Accordingly, tax incentives have provided the only major inducement for investment in low-income family and elderly rental housing during the past two decades. Furthermore, the existing inventory of low-income housing financed by HUD and Farmers Home will need refurbishment in the future. In the absence of tax incentives to invest more capital in elderly and low-income housing, the Federal Government runs the risk of having this low-income housing turned back to it. Both Houses of Congress have recently included funds for section 515 in their budget resolutions for fiscal year 1986, indicating a Congressional desire that these important programs continue. However, this congressional action will become a nullity if the administration's tax proposals, doing away with the traditional incentives to build low-income rental housing, are adopted. CRHD thus views it essential that the past practice of more favorable tax treatment for low and moderate income housing be continued. Mr. Chairman, I would also like at this time to make a few comments on a study that was just, frankly, completed for publication yesterday. The study was prepared for the Tax Fairness for Housing Coalition, of which CRHD is a member, by the Joint Center for Housing Studies at MIT and Harvard Universities, and the Horton Econometric Forecasting Associates, Inc. The conclusions are striking. Newly constructed apartment units receiving tax incentives under present law, including tax exempt financing, that rent, for example, for $319, would have to rent for $539 under the administration's tax proposal to be financially feasible. Because such higher rents are not obtainable in the market, there would be an annual 160,000 unit decrease in the production of new rental units. The resulting doubling up of households will result in lower housing quality for hundreds of thousands of families. For existing units, the study predicts that by 1991 rents would increase by 20 to 24 percent over nontax reform levels. Even assuming rent increases more modest than the 20-percent figure, such increases would more than offset any advantage low and moderate income households might gain as a result of the proposed tax cuts. The study points out that a married couple in a renter household, with two workers earning less than $25,000 a year could expect tax savings of less than $100 a year. However, assuminng just a 10-percent rent increase, their annual rental expenses would jump from $350 to $600 per year.

The CHAIRMAN. I have to ask you to conclude, Mr. Shepard.

Mr. SHEPARD. Those are my basic comments, and I would be more than happy to answer any questions you might have on specifics of the legislation.

The CHAIRMAN. I think there will be questions.

Mr. SHEPARD. Thank you.

The CHAIRMAN. Mr. Zigas? Do I pronounce it right?

[The prepared written statement of Mr. Shepard follows:]

Council For Rural
Housing And Development

Testimony of Joseph A. Shepard
President
Council for Rural Housing and Development

Committee on Finance
United States Senate

July 16, 1985

My name is Joseph A. Shepard. I am Chairman of The Lockwood Group, Webster Groves, Missouri, and also President of the Council for Rural Housing and Development, on whose behalf I am testifying today. The Council is composed of over 150 organizations who develop and finance low income family and elderly rental housing in rural America under the Section 515 program administered by the Farmers Home Administration. We appreciate this opportunity to suggest to the Committee changes to the Administration tax proposal that are essential if such housing is to continue to be built in this country.

An important preface to my remarks is the underlying rationale for the favorable tax treatment accorded by Congress to low and moderate income housing in all tax legislation for the past two decades. Congress acted purposefully and knowingly in making these incentives available, realizing that without them very little such housing would be built.

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Basically, there are three incentives that attract developers to build any real estate development. They are cash flow, possibility of appreciation, and income tax benefits. In the case of low income rental housing, the first two elements are missing. Generally, under federal or state housing assistance statutes, the cash flow is limited to a very low percentage return on investment. In addition to tight restraints on the return on investment, the government also controls the rents of any given development. Further, with low income tenants, there is a practical market limit on what rents can be charged.

Generally, rental projects for lower income families and elderly do not show significant appreciation in the market. With the government guaranteed or subsidized mortgage comes tight rent control and cash disbursement control. Even if these government controls were to be lifted, many of these developments still would not experience substantial appreciation because small room sizes and lack of amenities make such projects unable to compete at competitive market rent levels. In addition, they are very low on the target list for possible condominium conversion. In any event, such conversions are precluded by a generally applicable requirement that "locks in" such housing for rentals for twenty years. Thus, absent unusual circumstances, the chance for appreciation just is not there.

Accordingly, tax incentives have provided the only major inducement for investment in low income family and elderly rental housing during the past two decades. The situation is now exacerbated by the fact that the government has virtually no program to subsidize the construction of new rental units. The only remaining exception is the Section 515 program of the Farmers Home Administration for the construction of rental units for low income families and elderly in rural areas. However, as stated above, the Section 515 subsidy alone is not enough to induce developer participation in view of the rent control and the limitation of return on equity, and the very small likelihood of significant appreciation of the project.

Further, the existing inventory of low-income housing financed by HUD and FmHA will need refurbishment in the future. In the absence of tax incentives to invest more capital in elderly and low income housing, the federal government runs the risk of having this low-income housing turned back to it.

Both houses of Congress have recently included funds for Section 515 in their budget resolutions for Fiscal Year 1986, indicating a Congressional desire that these important programs continue. However, this Congressional action will become a nullity if the Administration's tax proposals, doing away with the traditional incentives to build low income rental housing, are adopted.

CRHD thus views it essential that the past practice of more favorable tax treatment for low and moderate income housing be continued. The following is an analysis of the key Administration proposals affecting the development of Section 515 housing and our recommendations as to how they should be modified so that the development of such housing - as well as other low and moderate income housing - can continue.

I. At Risk

The Administration would extend the current "at-risk" rules to all real estate. We believe it essential that the present "at-risk" rules be preserved for all rental housing with respect to unrelated third party arms length lenders (banks, insurance companies, federal, state and local agencies, etc.). Further, the present rule should be maintained in the case of low-income family and elderly housing for seller financing, which is subject to controls established either by FmHA, HUD or by the appropriate state housing agency.

As a practical matter, very few, if any, developers of low income housing projects would risk personal liability by investing in additional housing. The low income of the tenants coupled with the perceived extra wear and tear on the property make the risks all too real, especially in comparison with alternative investments such as shopping centers.

On this point, we may not be too far from the Administration's position. The proposal on at-risk suggests that Congress may wish to consider limiting the scope of the rule in the case of real estate to those cases where there are artificially inflated values. This would not be the case when there is an independent third party lender such as a bank or a state or federal agency. In addition to being consistent with the Administration's position, the exception also would be consistent with the preliminary position taken by the Treasury in its negotiations with the Department of Housing and Urban Development that would have exempted low income housing from the new real estate at-risk positions.

There should also be a narrow exception for seller financing in the case of transfer of federally and state assisted projects, such as Section 515 projects. There is strong public policy in favor of infusing new money into older projects and this only occurs on a sale. Some seller "take back" financing is necessary to make a sale feasible, as there generally is not the cash available to pay the seller in full in an elderly or low income family housing project transaction.

II. Interest Deductibility

In contrast to the Administration's proposal, we believe it essential that the interest of a limited partner be categorized as "business interest" not subject to the investment interest limitation. At the least, there should be a permanent exemption from the proposal for low income family and elderly housing.

It is illogical to say that one's interest paid as a part of an investment in a limited partnership is any less business interest than interest paid for investment in a general partnership or a sole proprietorship. This distinction is so illogical that it cannot support the drastic tax treatment difference proposed by the Administration.

At the very least, low income family and elderly housing should be excepted from this interest deductibility limitation. As emphasized in our introduction, tax incentives are an absolute necessity to make such projects feasible and the ability to deduct interest paid is a key part of such incentives.

III. Depreciation

We believe it essential that Congress retain the current 15-year depreciation period, 200% declining balance method for low income housing instead of lumping such housing in Category 6 under the Capital Cost Recovery System proposal.

Let us again emphasize how important it is for low income elderly and family housing to have extra incentives under the tax law. In the past, because of the absence of a cash on cash return, low income housing has always enjoyed different depreciation treatment from other rental housing in particular, and all real estate in general. Putting such housing in the same category as all other real estate eliminates this important differential, thus effectively ending the development of such housing.

IV. Construction Period Interest

We strongly oppose the Administration's proposal to repeal Section 189 permitting current deduction of construction period interest for low income housing. This provision should be retained as Section 189 of the Internal Revenue code now provides an incentive to construct low-income housing by providing an immediate deduction for interest expenses incurred. Along with accelerated depreciation, this is a major incentive that makes possible the production of low and moderate income housing. For that reason, this incentive should be retained.

V. Capital Gains

We urge Congress to provide an exception for low income family and elderly housing to the Administration's proposal to eliminate capital gain treatment for depreciable property.

The Administration proposal discriminates among different types of capital items. It is public policy turned upside down to propose that a six months stock market speculation deserves capital gain treatment while long term investment in apartments that house elderly and low income families does not. To begin with, elderly and low income family housing projects have less than the usual appreciation. Subjecting such appreciation to ordinary income on sale would make these investments even less attractive. Moreover, the Administration's proposal discriminates against hard assets in favor of highly liquid paper assets.

VI. Other Proposed Changes

The Administration proposal contains other changes affecting the development of rental housing. They include the elimination of tax exempt bonds to finance rental housing, the repeal of the five year write-off for rehabilitation expenses (Section 167(k)), and the elimination of the historic tax credit which can be utilized for multi-family renovation. Developers of rural housing under the Section 515 program rarely use these incentives since Section 515 is for the most part new housing that is directly financed by the Farmers Home Administration. However, from an overall perspective, these changes, especially the elimination of tax exempt financing, effectively eliminate the possibility of any development of rental housing for elderly and low and moderate income families no matter where located.

Transition Rules

One of the most troublesome aspects of the Administration's proposals are that they already have effectively stopped the development of real estate, including low income rental housing. This is true because generally the Administration's proposals apply to all projects where the property will not be placed in service by December 31, 1985. This transition date is in sharp contrast to the prevalent practice in the past of exempting those transactions where a "binding contract" has been entered into by the effective date.

The lack of a reasonable transition rule affects real estate development at every stage. Many projects now under construction cannot be completed before January 1, 1986. Accordingly, developers who have started a project under one set of tax assumptions now find that they are operating under far less favorable ones. The "placed in service" rule also assures that many projects not yet started will not be started as it is too late in the year to start and complete a project by December 31. Thus the Administration's proposal is choking off significant development activity at this time. This is most unfair to developers who have incurred significant pre-construction expenses in land options, architectural fees and the like, to say nothing of loss of jobs by construction workers, or tenants' loss of housing.

Accordingly, if adopted at all, the new depreciation schedule, the "at risk" provision and the change in capital gain treatment should not be applicable if a binding contract for the construction of a project is entered into before January 1, 1986 or the effective date of the Act, whichever shall be later.

Concerning the non-deductibility of interest by a limited partner, the $5,000 limitation ($10,000 in 1986 and 1987) would be phased in over a 10 year period, so that beginning in 1986 only 10% of interest under the proposed change would be subject to limitations. 20% would be subject to the new rule in 1987, with an additional 10% included each year until full phase-in in 1995. However, the proposal is still retroactive and unfair as it applies to investors in existing limited partnerships who made their investment on the good faith assumption that their investment interest would be deductible. Accordingly, the proposal, if enacted at all, should have an exception to the January 1, 1986 effective date in the case of interest from investments entered into prior to January 1, 1986.

Thank you for the opportunity to appear before you today.

STATEMENT OF BARRY ZIGAS, PRESIDENT, NATIONAL LOW INCOME HOUSING COALITION, WASHINGTON, DC

Mr. ZIGAS. Yes, you did, Mr. Chairman. Thank you. Mr. Chairman and members of the committee, my name is Barry Zigas, and I am president of the National Low Income Housing Coalition. We are a national organization representing tenants in assisted housing, nonprofit development organizations, developers and managers of assisted housing. It is a pleasure to be here today, and I appreciate the opportunity to share our views with you on President Reagan's tax reform proposals.

First, let me say at the outset that low income Americans today face a genuine and very pressing housing crisis. Over 4 million households today still live in substandard housing. Over 7 million very low income households are eligible for Federal housing assistance but do not receive it. Over half of the renters with incomes below $7,000 a year, which was about 50 percent of the renter median in 1983, at that time paid more than 60 percent of their income for rent. An even higher percentage of those with incomes below $3,000 did so. A recent GAO report revealed that over 10 years ago 54 percent of renters with incomes below 80 percent of the median—those section 8 eligible—paid more than 30 perent of their income for rent. Ten years later, in 1983, that had increased by 10 percent to 64 percent of them. For the vast majority of these tenants, the major problem is the affordability of the housing they occupy. But a reduction in the tax-based subsidies will probably lead, as we have heard, to higher rents generally for low income tenants and, with low income tenants already paying thse ridiculously high rent burdens, this would be an insufferable burden. Since 1980 meanwhile, the Federal role in housing has been reduced drastically. As Senator Heinz mentioned earlier, we have had low income housing spending reduced by over 60 percent by 1981. There are no remaining substantial direct subsidies for housing development or rehabilitation for low income people, and there has never been anything like this kind of withdrawal from what has been, until now, a 50-year bipartisan commitment to the goal of a decent home and a suitable living environment for every American. Compare if you will the direct spending cuts that we have suffered in the last 5 years with tax policy and tax spending. While low income spending has been slashed, high-income spending on housing is up to record levels. This year, according to the Joint Tax Committee, over $40 billion will be spent on subsidizing upper income home owners, and over half of that will be for mortgage interest deductions. And $10 billion will be spent directly on low income people in rental subsidies, and about $6 billion in various tax preferences and subsidies—those we are discussing today—will be lost in revenue. Tax incentives are the only remaining source of funding to underwrite low income development and preservation. My message today to you is that low income Americans do face a crisis, that the Congress has already made a decision in its budget and appropriations and authorizing policies to say no to increased and even stable direct spending on low income housing needs. The result has been, for low income people, soaring rent burdens, overcrowding, and homelessness. The withdrawal of the current tax

subsidies will eliminate the only remaining presence of the Federal Government in low income housing development and/or preservation. And what will the effects of this be? Potentially, higher rents for the very lowest income people in the country, potentially disastrous effects on the existing stock of low income housing already insured and, in some cases, subsidized by the Federal Government, and a withdrawal of the private sector from new initiatives that we see cropping up in cities around the country to take advantage of these incentives to support nonprofit development of low income housing and community development. The current system is not perfect, Mr. Chairman. It could and should be better targetted. My testimony reviews a number of areas where we could do this to establish uniform definitions of income, adjust income for family size, provide for the use of tax-exempt bonds to finance blanket mortgages for limited equity, low income cooperatives, and other means. But Congress must understand that the price of the elimination of the current situation will be very high for the low income renter. It will not be paid by high income investors. It will not be paid by middle men and brokers. In the end, it will be paid by low income people already suffering unprecedented high rent burdens, partially as a result of the deliberate withdrawal of the Federal Government from direct spending programs on their behalf. The proposal is consistent with many other administration proposals we have seen in the last 5 years.

Low income housing spending was cut, so we could reduce the Federal budget deficit. So, low income housing is down by 60 percent, and the budget deficit has more than tripled. Now, low income people are told that the only remaining federally financed low income development incentives should be repealed in the name of equity. Yet, the true, real subsidies for housing—those for wealthy home owners—are not being touched, not even discussed. These provisions can and should be improved. We stand ready to work with the committee and its staff to try to improve them and simplify them and make the subsidies more direct and more beneficial to low income people. The Congress would be acting irresponsibly if it followed the disastrous budget cuts for housing assistance for the poor with the elimination of these remaining incentives and no replacement.

[The prepared written statement of Mr. Zigas follows:]

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Barry Zigas, President

STATEMENT OF

BARRY ZIGAS

PRESIDENT
NATIONAL LOW INCOME HOUSING COALITION

ON TAX REFORM PROPOSALS AND LOW INCOME HOUSING

BEFORE THE
COMMITTEE ON FINANCE
U.S. SENATE

JULY 16, 1985

Mr. Chairman, distinguished members of the Committee, my name is Barry Zigas. I appear before you today as President of the National Low Income Housing Coalition. The Coalition is an national organization of individuals and organizations providing advocacy services for low income housing. I appreciate this opportunity to share our views on the Administration's tax reform proposals with you.

Mr. Chairman, the need to overhaul the income tax system is clear and undeniable. The unfairness of the present Code, its complexity, and its inefficiency in meeting social and fiscal goals are well-documented. However, unless the Congress is willing to make drastic changes in its other fiscal priorities at this time, it must categorically reject the President's proposals to eliminate the current incentives in the Code for investment in the preservation and development of housing which is affordable to and occupied by low income households.

Although the President's proposals are touted as increasing equity and fairness in the Code, the proposals which relate to housing have exactly the opposite effect. The proposals leave untouched the most inequitable and biased portions of the Code relating to housing and wreak havoc on those which provide some measure of benefit to lower income housing consumers. Many billions of dollars in lost tax revenue which are limited almost exclusively to high income homeowners would be protected under this plan. At the same time, the meagre subsidies now provided to encourage low income housing would be eliminated. On equity considerations alone, these proposals should be rejected.

Mr. Chairman, my statement will cover the following areas:

o What is the current need for low income housing assistance?

- o What are the characteristics of those who receive direct housing assistance?
- o What are the trends in federal support for housing assistance, and who really benefits from the current system of support?
- o What effects will the tax reform proposals now before you have on low income housing preservation and development?

WHO NEEDS HOUSING ASSISTANCE?

The implications of the President's tax reform proposals for low income housing cannot be fully understood without an appreciation for the magnitude of the housing crisis currently confronting low income people. Despite 50 years of federal effort to reach the goal of a decent home in a suitable living environment for all Americans, in 1985 millions of low income people live in inadequate shelter, and/or pay exorbitant amounts of their income for housing costs.

Over the years, many different attempts have been made to quantify the unmet need for low income housing. In 1981, President Reagan's Commission on Housing found that over 7 million very low income renter households either lived in substandard housing, and/or paid more than 30 percent of their income for rent. Since 1981, the 30 percent of income standard has been used as a benchmark for housing affordability. This figure is an increase from the traditional and familiar measure of 25 percent of income. In itself, this increase masks a substantial degree of housing need which the lower figure would reveal. Even with the increased figure, however, the need is overwhelming.

In 1983, the Annual Housing Survey found that median renter income was $12,900. At the same time there were 8.4 million renter households with incomes below $7,000 per year, or roughly 50 percent of the renter median. Among these renters,

- 90 percent paid more than 25 percent of their income for rent.
- 80 percent paid more than 35 percent of their income for rent.
- 55 percent paid more than 60 percent of their income for rent.

Among the 2.2 million households with incomes below $3,000 per year--the lowest income group identified in the AHS--over 80 percent paid more than 60 percent of their income for rent.

In an analysis of 1980 Census information, the Low Income Housing Information Service found that more than twice as many renter households are in need of low cost housing than exists to serve them in the private market. While over 7 million renter households were idenitified by the Census as earning 50 percent or less of the renter median income, only about 3 million units were identified as renting at or below 25 percent of 50 percent of renter median income. Moreover, since 1970, while the number of very low income renters has decreased, the gap between their need for affordable housing and the amount of housing affordable to them in the market actually grew by over one-third.

Low income housing need is not confined to renters. The 1983 AHS showed that the median income of owners with homes with mortgages was $31,000. However, owners at or below 50 percent of the median represented only 16 percent of owners with mortgages, despite the fact that there are nearly as many owners as renters with incomes below $10,000. While only 24 percent of all the morgtgaged owners paid more than 30 percent of their income for gross housing costs, 78 percent of the owners with incomes at or below 50 percent of the median did. While only 5.9 percent of all owners with mortgages on their homes paid more than 60 percent of their income for shelter costs, 93 percent of those with incomes below $3,000 did, 62 percent of those with incomes between $3,000 and $7,000 did, and 30 percent of those with incomes between $7,000 and $10,000 did.

There are a number of ways to determine low income housing need. While other federal assistance programs rely on measures relating to the poverty income level, HUD's assisted housing programs have since 1974 relied on a different measure. Under HUD's programs, "low income" is defined as income below 80 percent of the area median income. "Very low income" is 50 percent or less of area median. In our discussions, we have used 50 percent or less of renter median income, which is a much more restrictive definition than either poverty level or HUD's. Yet even using this highly restrictive definition, the need is staggering.

Under a variety of programs enacted since 1937, the federal government has succeeded in bringing its inventory to almost 4 million households under subsidy in 1985. Altogether, about 10 million individuals are served in these programs. Yet by any measure, this total falls far short of meeting the low income housing crisis. Participation in low income housing programs is still a matter of patience and luck. Recent surveys have shown that the average waiting list for assisted housing in a cross section of cities is 20 months. In one city, the wait for Section 8 Existing Housing Certificates for families is over 300 months, or nearly 30 years! Cities routinely close their waiting lists to new applicants because current applicants have so little chance of receiving assistance.

The table below shows how many renter households were served by federal housing assistance programs according to the 1980 Census.

Table I

Renter Households by Selected Measures of Need, 1980
(Households in thousands)

	Below Poverty level	Below 125% of poverty	Below 50% of median	Below 80% of median
Renter households	8,956	9,204	11,154	16,833
In subsidized housing	1,430	1888	2,405	2,680
Not in subsidized housing	7,526	7,316	8,749	14,153
% in subsidized housing	16.0%	20.5%	21.6%	15.9%

Source: U.S. Census data. Prepared for presentation by Cushing N. Dolbeare, Chair, National Low Income Housing Coalition.

The inability to pay the cost of decent housing translates into poor housing quality, as well as high rent burdens. Almost three-fifths of all renters living in substandard or overcrowded housing in 1980 had incomes below $7,000 per year. Owners faced a similar dilemma: the lower their income, the more likely they were to be consumers of substandard housing, regardless of their rent or housing cost burdens.

WHO LIVES IN LOW INCOME ASSISTED HOUSING?

Recent Census reports on recipients of non-cash benefits provide a clear and illuminating picture of the residents of HUD's low income housing assistance programs. Among the 3.2 million households living in either public housing or

Section 8 units, the median income in 1984 was $6,275, or about 30 percent of the national household median of $20,885. Only 23 percent of the 7.5 million renter households living below the poverty level lived in these units in 1984, an increase since 1980 Census counts were published. Fifty-two percent of the residents in these units live below the poverty level.

A majority of the residents of public and Section 8 housing are senior citizens or female headed households. The majority of the latter live in families with minor children present. Fully 43 percent of these households receive Food Stamps; 45 percent receive Medicaid; and 28 percent receive AFDC payments. About two-thirds of the tenants are classified as having no cash income.

In short, HUD's assisted housing programs overwhelmingly serve the poorest households in the nation. Tenants in these programs are most likely to represent population groups which have special needs--the elderly and single parent households with minor children--and are least likely to be able to compete effectively in the private housing market.

THE TREND IN DIRECT ASSISTANCE FOR LOW INCOME HOUSING

While the need for affordable low income housing has grown dramatically over the last 10 years, and remains at crisis levels despite 50 years of federal intervention, the last five years have seen an unprecedented withdrawal by the federal government from a 50-year bipartisan tradition of support for the goal of providing every American family with a decent home in a suitable living environment at an affordable price.

Since 1981, appropriated budget authority for low income housing assistance has been cut by over 60 percent, from $31 billion in FY81 to $10 billion in FY85. Tenant rents have been increased by 20 percent, from the traditional 25 percent of income to 30 percent of income. Subsidies for the construction and rehabilitation of housing for low income people has all but ceased. The Section 8 New Construction and Substantial Rehabilitation programs were repealed in 1983. Only the Section 202 program for housing for the elderly and handicapped remains to provide federal development assistance to low and very low income people.

Instead of subsidies for the renovation and construction of housing, the federal government has placed the major emphasis of its federal housing assistance efforts on providing subsidies to tenants in existing housing, through the Section 8 Existing Certificate program and a new, demonstration program of vouchers. Unfortunately, this shift in emphasis has been accompanied by the largest reductions in funding for any single domestic discretionary spending program.

To illustrate the ground which has been lost through this budget reduction, assume only that the Congress had abolished new construction and rehabilitation programs and shifted the entire FY81 budget authority allocation for HUD to existing housing programs. This $31 billion would have been enough to provide an entitlement to Section 8 Existing Housing assistance to every household eligible to receive it. And when every household had been served, HUD could have returned over $5 billion in budget authority to the Congress for use in other programs!

Instead, Congress approved massive cuts in assistance. In 1985, fewer households are being added to the inventory of assisted housing than at any time in the last 10 years. Meanwhile, homelessness is raging in cities throughout the country, housing authorities report they are experiencing unprecedented overcrowding in the units they manage, and rent burdens among low income households are skyrocketing.

THE TREND IN HIGH INCOME HOUSING ASSISTANCE

The federal government has always been particularly generous in assisting middle and upper income Americans cope with their housing burdens. With the advent of federal mortgage insurance in 1934, and the boom in homeownership which started after World War II, major subsidies began to flow through a variety of provisions in the federal tax code. The most expensive of these subsidies—income tax deductions for mortgage interest and property taxes—were not even deliberate attempts to subsidize homeownership. However, they have become enshrined in the American tax lexicon as housing subsidies which are necessary and justifiable to help people achieve the "American dream" of homeownership.

The true role of these deductions in creating a nation of homeowners is debatable—only a third of all taxpayers actually itemize their returns, and among all homeowners, less than half do so. What is clear, however, is the dollar value of these deductions to those who are fortunate enough to receive them.

In 1986 alone, the Joint Committee on Taxation estimates the combined cost to the federal government of homeowner tax expenditures at over $40 billion. Over one-half of this subsidy is accounted for by mortgage interest deductions, and another quarter by those for property taxes.

This spending, which dwarfs the $10 billion in outlays HUD will make in FY85 on behalf of low income households, is unusually well targetted—to very high income households. According to CBO and Treasury Department analyses, over 70 percent of the dollar value of these expenditures flows to taxpayers with incomes above $30,000 per year. These are families earning 150 percent of the national household median, and over twice the median income of renters. And the flow of subsidy is disproportionately beneficial the higher on the income scale you are. There are no effective restraints on this spending. In FY86, while the Administration proposed a total elimination of any additional assistance for lower income housing subsidies, OMB projected a 10 percent increase in tax subsidy spending on behalf of homeowners. Such outlays are uncontrolled, unmonitored, and unrecoverable.

THE TAX REFORM PROPOSALS

In light of the severe reductions in direct spending on behalf of low income people's housing needs in the last five years, housing advocates, developers and owners have come to rely to an increasing degree on investor incentives in the Tax Code to provide the subsidies necessary to provide affordable housing to lower income households. The use of these incentives is not new. They have been used in conjunction with most of the development-oriented subsidy programs of past years. But in the absence of direct spending programs to assist low income people, tax expenditures which favor low income housing have become the only means available to preserve and expand the supply of housing affordable to low income people.

The tax reform proposals announced in late May would eliminate every single one of the investor deductions which encourage investment in low income housing.

The budget savings from these proposals are modest—total spending through these investor deductions and tax exempt financing will amount to about $6.9 billion in FY85, according to the Joint Committee on Taxation. That is about 13 percent of all housing-related tax expenditures. The chart at the end of my statement shows the relationsihps among the different forms of tax subsidy over the years 1984-1990.

The specific provisions of the Code in which the Administration's proposals would jeopardize low income development are the following:

- o elimination of the 5-year write off of rehabilitation expenses through Section 167(k);
- o elimination of the preferential depreciation period currently allowed for low income housing investments;
- o elimination of the 25 percent tax credit for historic preservation;
- o extension to real estate partnershisp of the at-risk rules;
- o change in the capital gains treatment of real estate profits; and
- o changes in the deductibility of interest paid by partnersips.

In what specific ways will the tax reform proposals affect low income housing? First, the elimination of investor tax preferences will jeopardize the preservation and liveability of thousands of units of existing housing subsidized through special FHA mortgage insurance programs. Many thousands more which currently receive no subsidies will also be placed in jeopardy. The bulk of the FHA-insured and subsidized stock of housing constructed under the Section 236 and 221(d)(3) programs for low income renters is reaching the end of the recapture period for tax benefits already taken. At the same time, many of these buildings need the modernization and repair work any property in service for nearly 20 years requires. The original investors, faced with the end of the recapture period and the need for additional capital investment to preserve the units, are either selling out their interests entirely, or seeking to recapitalize their original investments to provide new cash for the needed work. The rents which current tenants are able to afford will not be sufficient to capitalize the needed maintenance work and ongoing operations, as well as transaction costs without subsidies. There are no direct subsidies available to underwrite this work. Tax preferences thereby become a critical factor in making the reinvestment in these properties economically feasible. They are also a major factor in attracting investment into these properties in the first place.

A second major area in which the tax proposals will hurt low income housing is housing rehabilitation. Through the five-year write offs provided through Section 167(k) and the incentive of the historic rehabilitation tax credit, investors throughout the country are encouraged to invest in rehabilitation projects which provide housing opportunities on a highly targetted basis to low income tenants. This program's cost is minimal. But without this incentive and others like it, there is little likelihood that investors will be attracted to any rehabilitation projects involving low income housing.

Finally, what little development is going on today to provide affordable housing resources through tax exempt financing of multifamily and single family housing by state and local agencies would be stopped dead by the Reagan tax proposals. Wholesale displacement of existing tenants is epidemic throughout the country as developers purchase and rehabilitate older rental properties for luxury rental or condominium markets. Without the use of federally subsidized tax exempt mortgage funds, there is no reasonable means by which to mitigate this displacement, or offer tenants an affordable alternative to private sector development of existing housing resources. Even with IDB financing, the subsidy is too shallow, as this Committee and others have heard in recent weeks. But without IDB financing, there is absolutely no chance that even the minimal displacement mitigations which have taken place could have been structured.

THE NEED FOR REFORM

The current tax incentives for low income housing investment are far from perfect. In a perfect world, the government would take the Treasury Department's advice, and consciously decide to subsidize rental housing for all low income people who need it. The Administration would request adequate funds for such an effort, and would run it efficiently. Congress would face up to its obligations and appropriate sufficient funds to underwrite such a program.

We are not living in a perfect world. Congress in the last five years has agreed with the Administration that the need for deficit reduction outweighed the need for low income housing assistance. The result has been massive cuts in direct spending for low income housing rental assistance. The federal government has withdrawn almost completely from direct subsidies for housing development.

The consequences of these actions should be clear. Homelessness is on the rise in almost every major city in the nation. Rent burdens and overcrowding are higher than at any time in the recent past. Meanwhile, the federal budget deficit has more than tripled. Low income housing has been sacrificed, and to no apparent good effect.

Despite these cuts, nonprofit development groups and other sponsors continue to find ways to preserve and expand the supply of affordable housing for low income people. Without direct subsidies, these efforts rely almost exclusively on a combination of tax subsidies and local and state government intervention. As they operate today, they provide only a small fraction of the housing we need. But they are the only devices left to carry on this task.

The tax preferences slated for elimination in these proposals serve to attract investment capital into projects in the first place. They also create the means by which rents can be lowered sufficiently to begin to be affordable by people in the upper reaches of the eligible income group for low income assistance.

The tax preferences are inefficient. They are insufficiently targetted. Too much of the benefit fails to reach low income people. The tax system alone is a lousy way to meet the housing needs of low income people.

But the tax system is the only way left for those of us trying to serve low income people. The elimination of the tax preferences might serve some ideal goal of tax purity. But the direct result of repeal would be to close off the last remaining means by which low income housing needs can be met in a small way.

There are reforms which Congress could enact to increase the benefits these programs provide to low income people. For instance, all of the deductions and allowances should be based on a uniform definition of low and moderate income, rather than the hodge-podge currently in place. Tax advantages for low income housing development should be available only where the units serve those with incomes below 80 percent of the area median income. Moreover, incentives should be deeper for units which serve those with incomes below 50 percent of the area median, to encourage development of units for those most in need.

When calculating tenant income under these preferences, adjustments should be made for family size. The qualifying income of a single person should be lower than for a family of five. Sponsors and developers using the tax preferences should be required to lower costs for the assisted units so that they are available to a range of family sizes at rents which are reasonable for the family size.

Congress should explore increasing the percentage of units which must be allocated to low income residents to qualify for tax exempt financing. Currently, at least 20 percent of the units must be set aside for lower income households. We believe this could be increased without destroying project economics in many, if not all such deals.

Strong incentives should be placed in the Code to encourage owners of rental housing to sell to tenants, rather than new outside investors. These incentives might include a complete forgiveness of any capital gains for such sales. Congress must act to provide incentives in the tax system which will encourage the conversion of older rental units to cooperative or others forms of ownership by the tenants now in place. The alternative is a continuing destruction of affordable housing resources through speculation.

Other reforms may be possible in these programs to target them more highly. And there is nothing sacred about the various forms which tax preferences have taken over the years. Perhaps more effective ways can be found to achieve the same goals of equity attraction and cost reduction to low-income consumers.

The proposals presented by the Administration, however, must be rejected in their current form. Unless Congress is prepared to replace these incentives with dramatic increases in direct spending, or new, more efficient means of tax subsidies, the current system should not be eliminated. The savings to the Treasury would be minimal. The damage to low income housing consumers would be tremendous. And by bypassing any reform of homeowner mortgage deductions, Congress would be violating its own and President Reagan's first proposed test by which to judge any tax reform: equity and fairness.

REVENUE NEUTRALITY

The preservation of tax preferences for low income housing will affect the revenue totals raised after a tax overhaul. But providing tax incentives for low income housing investment need not be a "budget buster". First, the amounts involved are small, both in absolute and relative terms. But more importantly, Congress could raise offsetting revenue through tax reform which would shift the tax burden away from low income renters and more toward those better able to afford it.

For instance, Congress should consider reforming the mortgage interest deduction provisions of the Code. The Administration's proposal to cap such deductions to principal residences is sound in principle. Other steps could also be taken. The amount of deductions could be capped, so that owners in the very highest tax brackets receive somewhat less in deductions. The entire deduction could be shifted to a refundable credit, which would shift its benefits substantially toward those with more modest incomes. At the same time, the amount of the credit could also be capped.

The Administration's proposal to eliminate deductions for state and local property taxes, by itself, will do substantial harm. But Congress should consider shifting this to a capped, refundable tax credit. This would shift the benefits further down the income spectrum, allowing many owners who do not currently take advantage of the deduction to do so. It would also limit tax losses taken by the very wealthy, and raise some revenue in the process.

Congress should also consider modifying some of the other tax preferences provided owners. If the total deferral of capital gains on housing sales were to be modified to provide only a partial deferral of gains up to a certain limit, and the balance taxed at a very low rate, substantial amounts of new revenue would be raised. The impact on individual buyers and sellers would be minimal.

In all these examples, Congress should take the revenues raised and earmark them for spending to preserve and expand the supply of low income housing.

Congress must remember that the tax code as currently structured provides the vast bulk of its subsidies in housing to the very rich. Analysis of tax returns by the CBO and Treasury Department show that over 70 percent of the dollar value of the homeowner deductions flow to taxpayers with incomes above $30,000, or 150 percent of median. According to the Joint Committee on Taxation, not even half of all taxpayers even claim the deductions until income rises to $30,000 or more. And the volume of benefits is heavily skewed toward the very wealthy. The average dollar value of the mortgage interest deduction per taxable return is only $3.70 for taxpayers earning under $10,000. But it rises to $415.50 for taxpayers in the $30,000-$40,000 range, and soars to $2,509.09 for those with incomes of $200,000 and more.

In the weeks to come, the National Low Income Housing Coalition and the groups with which we are working on tax reform will be availble to you and your staffs at any time to review new proposals, to expand on this presentation, and to assist Congress in developing a progressive and equitable retooling of the Code. I appreciate this opportunity to share our views on tax reform with you, and will be happy to answer any questions you may have at this time.

Housing-Related Tax Expenditures, 1984-1990
(in billions of dollars)

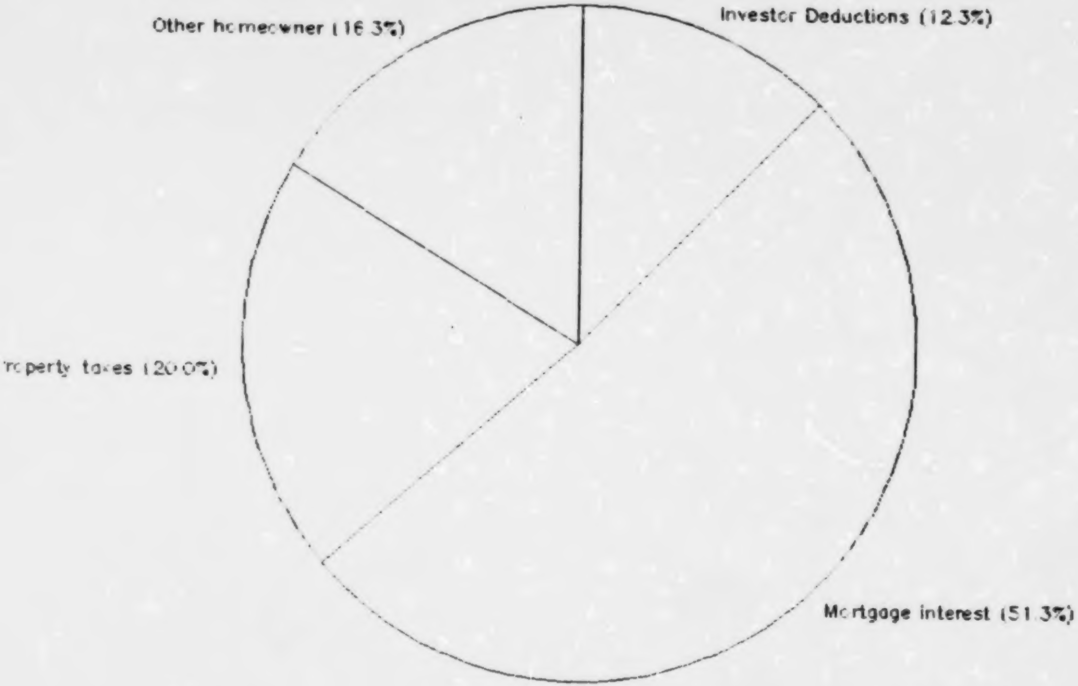
	1984	1985	1986	1987	1988	1989	1990
Historic structure preservation							
Corporations	0.1	0.1	0.3	0.3	0.3	0.4	0.4
Individuals	0.2	0.3	1.2	1.4	1.5	1.7	1.9
Subtotal	0.3	0.4	1.5	1.7	1.8	2.1	2.3
Exclusion of interest on rental housing bonds							
Corporations	0.7	0.9	1.1	1.3	1.6	1.8	2.1
Individuals	0.5	0.6	0.5	0.7	0.8	0.9	1.0
Subtotal	1.3	1.5	1.6	2.0	2.4	2.7	3.1
Mortgage revenue bonds							
Corporations	1.2	1.3	1.5	1.7	1.8	1.7	1.6
Individuals	0.5	0.6	0.6	0.8	1.0	1.1	1.0
Subtotal	1.8	1.8	2.1	2.5	2.8	2.8	2.6
Accelerated depreciation on rental housing							
Corporations	0.2	0.2	0.3	0.3	0.3	0.3	0.4
Individuals	0.7	0.7	1.4	1.4	1.4	1.4	1.6
Subtotal	0.8	0.9	1.7	1.7	1.7	1.7	2.0
Five-year amortization of low income housing rehab (167k)							
Corporations	*	*	*	*	*	*	*
Individuals	*	*	*	*	*	*	*
Total corporate	2.3	2.5	3.2	3.6	4.0	4.2	4.5
Total individual	1.9	2.1	3.7	4.3	4.7	5.1	5.5
TOTAL INVESTOR DEDUCTIONS	$4.2	$4.6	$6.9	$7.9	$8.7	$9.3	$10.0
Percent corporate	53.6%	54.3%	46.4%	45.6%	46.0%	45.2%	45.0%
HOMEOWNER DEDUCTIONS							
Mortgage interest	23.5	25.5	27.1	30.3	33.8	37.9	42.3
Property taxes	8.8	9.6	10.2	11.7	13.2	15.1	17.1
Subtotal	32.3	35.1	37.3	42.0	47.0	53.0	59.4
Capital gain deferral	4.9	5.6	5.9	6.4	6.9	7.5	8.0
Capital gain exclusion	1.6	1.9	2.0	2.1	2.3	2.5	2.7
Residential energy credit	0.0	0.0					
Supply incentives	0.4	0.5	0.6	0.1	0.0	0.0	0.0
Conservation incenti	0.3	0.3	0.3	0.0	0.0	0.0	0.0
Subtotal	0.6	0.8	0.9	0.1	0.0	0.0	0.0
	0.0	0.0					
TOTAL HOMEOWNER DEDUCTION	$39.4	$43.4	$46.1	$50.6	$56.2	$63.0	$70.1
Total corporate	2.3	2.5	3.2	3.6	4.0	4.2	4.5
Total individual	41.4	45.5	49.8	54.9	60.9	68.1	75.6
TOTAL HOUSING-RELATED	$43.6	$47.9	$53.0	$58.5	$64.9	$72.3	$80.1
Percent homeowner	90.4%	90.4%	90.9%	91.2%	91.5%	91.8%	87.5%
Percent investor	9.6%	9.5%	13.0%	13.5%	13.4%	12.9%	12.5%

Housing-Related Tax Expenditures, 1984-1990
(in billions of dollars)

	1984	1985	1986	1987	1988	1989	1990
Percent corporate	5.2%	5.2%	5.1%	5.1%	5.0%	4.9%	5.6%
Percent individual	94.8%	94.8%	94.0%	93.8%	93.8%	94.2%	94.4%
Sum of all tax expenditures							
Corporations	81.5	94.9	119.9	127.5	135.8	147.1	159.0
Individuals	248.0	270.3	304.6	333.1	361.6	399.0	438.9
Total	$329.5	$365.1	$424.5	$460.6	$497.4	$546.1	$597.9
Housing as percent of total							
Corporations	2.8%	2.6%	2.7%	2.8%	2.9%	2.9%	2.8%
Individuals	16.7%	16.8%	16.3%	16.5%	16.8%	17.1%	17.2%
Total	13.2%	13.1%	12.5%	12.7%	13.0%	13.2%	13.4%

* Less than $50 million (167k total for 1986-1990 is $2.0 billion)

Source: Joint Committee on Taxation, Estimates of Federal Tax Expenditures For Fiscal Years 1985-1990, April 12, 1985 (1984 and 1985 figures from 1984 report).



HOUSING-RELATED TAX LOSSES, 1984-90
(Joint Tax Committee estimates)

The **Chairman**. Thank you. Mr. Cymrot.

STATEMENT OF ALLEN CYMROT, CHAIRMAN-ELECT, NATIONAL MULTIHOUSING COUNCIL; AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, KEMPER-CYMROT, PALO ALTO, CA

Mr. **Cymrot**. Good Morning, Mr. Chairman and the committee. My name is Allen Cymrot. I am the president of Kemper-Cymrot, a real estate investment firm. I am also chairman-elect of the National Multihousing Council. That is the organization I represent this morning. Over the years, the Congress had deliberately created tax incentives for the production and preservation of rental housing. Those incentives have worked. Thanks to these tools which have stimulated rental housing production, American tenants have unprecedented supply of affordable rental housing. Thanks to these tools, in addition, rent increases have been substantially less than increases in the cost of home ownership. The President's tax reform proposal would reduce most of these incentives and would make rental housing unable to compete effectively for investment dollars. To understand the investment decision, you must realize that basically there are three components of investment return on rental housing. The actual cash resulting from tenant rents, the tax benefits available to investors, and the possible capital appreciation. Previously, there was a differentiation between construction, existing, and subsidy housing. Now, by homogenizing all three, I think a lot of the confusion exists in the fact that different witnesses appear before this committee with different points of view, depending on which weight is put onto each of these investments. A just-completed study by an economist from Harvard University and Wharton Econometrics Forecasting Associates, which I would like to introduce in full for the record at this time, indicates a 44-percent increase in the cost of capital. My own personal experience is, and I know this to be true, is that investors today who are willing to accept a cash return of perhaps upward of 6 to 8 percent along with tax benefits and potential appreciation would require substantially higher cash returns, such as in the areas of 12 or 13 percent without the tax benefits that currently exist. The only way this increased return can be achieved is by a substantial increase in rents. However, it is important to remember that the rental population is fundamentally low and moderate income individuals and families. The income of the average renter is only about half the income of the average homeowner. The Harvard Wharton Study estimates that by 1991, the cost of the anticipated decline in rental housing production will have increased on an average of some 20 to 24 percent more than it would have under the existing law. The Harvard study also found that most of those low- and moderate-income families pay more for their housing than they do in Federal taxes. Accordingly, this study found that these increases in housing costs would more than offset any savings these families have from the enactment of the President's proposal. As has previously been mentioned—but I think it important to mention again—for a family in the $25,000 earnings category, the tax savings would be approximately $100 a year. However, such a family paying $300 to $600 rent a month would find their housing costs increased to somewhere between $350 to $720 a year for just a 10-percent rent increase. That is upward of seven times the potential tax savings on the proposed reform. Further, the President's proposal would severely limit the ability of passive investors—today, one of the main sources of capital for rental housing—to realize the legitimate tax benefits attributable to their investment.

For example, mortgage interest deductions could be denied to investors, even for payments to a bank or to a third party lender with respect to rental housing held in a limited partnership or subchapter S corporations under the proposal to expand the investment interest limitation. The construction and ownership of rental housing typically requires substantial amounts of mortgage financing. Accordingly, this potential disallowance of the mortgage interest deduction, virtually by itself, eliminates rental housing as a competitive investment option for a large segment in the investment public. This narrowing of the potential investor market will dramatically increase the cost of investment capital for rental housing. Similarly, denying investors the tax benefits attributable to nonrecourse financing of rental housing through expansion of a so-called at risk rules to real estate would increase the cost of capital investing in housing with no corresponding economic benefit. The proposed changes affecting rental housing are not designed to correct abuses under current tax law.

Potentially abusive real estate transactions have been effectively dealt with under the 1983 and 1984 Tax Acts. Therefore, the issue you face and which the American people are entitled to know about is whether none abusive incentives should be eliminated at the price of a substantial increase to the cost of housing for one-third of the American public, with the inevitable reductions in their standard of living. Put another way, for some meager tax savings, do the people of this country want to pay significantly higher rates? Do they want more doubling up due to an inadequate supply of housing? I think the answers to these questions is obviously—no. Thank you very much.

[Laughter.]

[The Harvard-Wharton study is in the official committee files.]

[The prepared written statement of Mr. Cymrot follows:]

NMHC
NATIONAL MULTI HOUSING COUNCIL
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STATEMENT OF ALLEN CYMROT
ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 16, 1985
CONCERNING THE IMPACT OF THE PRESIDENT'S TAX REFORM PROPOSALS ON RENTAL HOUSING

Mr. Chairman and Members of the Committee on Finance, my name is Allen Cymrot. I am President and Chief Executive Officer of Kemper-Cymrot, Inc., a subsidiary of Kemper Financial Services. Kemper-Cymrot specializes in organizing and managing real estate investment programs in rental housing through limited partnerships.

I appear before you today as the Chairman-Elect of the National Multi Housing Council, which is a nationwide organization of over 6,000 members, representing all aspects of the rental housing industry. Together, NMHC members own or operate hundreds of thousands of rental units.

Four years ago, this Committee acted to alleviate a serious impending housing shortage by creating a new incentive for the production of rental housing: accelerated cost recovery ("ACRS"). This incentive, together with tax-exempt ("IDB") financing for rental housing, has worked. Since 1981, we have experienced three years of record rental housing production which has loosened once-tight rental housing markets and contained the real increase in rent levels to 6%, well below the real increase in the cost of homeownership. Affordable rental housing is now available for newly-forming and relocating households such as young married couples and elderly Americans. Even the once intense battles over the conversion of scarce rental housing to condominium use have abated, in part due to the constant new supply of rental housing being built as the direct result of these tax incentives.

The President's tax reform proposal eliminates all incentives for the production of rental housing from the Internal Revenue Code ("Code"). First, the proposal significantly curtails cost recovery benefits for real estate, especially in the early years of ownership. However, if a more realistic discount rate than 4% is used, the proposed CCRS depreciation is far less generous than ACRS throughout the life of a real estate asset. Moreover, the President's propoal recharacterizes the inflation-adjusted gain from the disposition of rental housing (which is treated as capital gain under current law) as ordinary income. Under current law, an investment in housing may be depreciated using the 175% declining balance method without increasing the amount of ordinary income (the excess of the accelerated depreciation over hypothetical straight-line depreciation) realized on disposition of the property. This ability to utilize accelerated depreciation without tax penalty, which is not available to investors in commercial real estate, has enabled housing to remain competitive and to attract the needed amount of investor dollars. Finally, the President's proposal eliminates tax-exempt IDB-financing as a source of low-cost mortgage capital for rental housing.

In addition, the President's proposal would severely limit the ability of owner/investors in rental housing to realize the remaining tax benefits attributable to their investment. For example, the expanded investment interest limitation could prevent an owner/investor from deducting mortgage interest payments, even if made to a bank or third party lender, with respect to rental housing held through a syndicated limited partnership or S corporation vehicle, unless the owner/investor happens to possess other significant income-producing investment assets. Because the construction and ownership of rental housing generally requires substantial mortgage financing, this potential disallowance of the mortgage interest deduction would elminate rental housing as a competitive investment option for a large segment of the investor public. Accordingly, the cost of any remaining viable investment capital will dramatically increase. A joint study by economists from Harvard University and Wharton Econometric Forecasting Associates using the Wharton Long-Term Model of the United States economy (hereafter, the "Harvard/Wharton Study") predicts a 44% increase by 1991 in the cost of capital for rental housing construction in excess of the anticipated cost of capital under a continuation of present law.

Syndication is a means of raising capital from small investors who wish to participate directly in all the attributes of the ownership of rental housing without taking an active management role. Such investors are attracted to rental housing because of its total investment return -- i.e. the combination of the cash return resulting from tenant rents plus the federal income tax benefits now available to investors in rental housing. This is exactly what Congress intended when these incentives were created: that private investors would respond to produce sufficient amounts of affordable rental housing to satisfy our country's housing needs. Without these tax advantages, moreover, rental housing cannot produce a rate of return which is adequate to attract private investment capital because the typical tenant cannot afford rent payments which are sufficient to that purpose. Accordingly, without the tax benefits currently in place, or without some other comparable subsidy, private investors will not produce rental housing for low and moderate income families.

In 1984, Congress enacted legislation designed to deal with a perceived abuse of ACRS depreciation in sales of real property where the depreciable basis of the property was overstated and the interest component of seller-financing was understated through use of a below market interest rate. The 1984 legislation now mandates the use of market interest rates for all debt instruments exchanged in sales of property, thereby eliminating the threat that buyers and sellers of real estate assets will contrive to maximize tax benefits. Moreover, the overwhelming majority of all mortgage financing of rental housing is arms-length, institutional financing. Now that the rare abuse cases have been addressed by recent legislation, there is no apparent justification for the Congress to deprive owner/investors in rental housing of the full amount of mortgage interest deductions attributable to their investment. Third-party mortgage interest payments and interest payments attributable to arms-length seller financing of rental housing are legitimate expenses incurred in a trade or business which should be fully deductible by owner/investors regardless of the form of their investment. These expenses are not comparable to the personal investment interest deductions now limited under present law.

Similarly, again because the amounts of borrowed capital necessary to finance an investment in rental housing are so large, investors of modest means otherwise desiring to share in the ownership of such property are understandably reluctant to bear the full risk of a loss. The President's proposal, however, would deny investors in real estate the tax benefits attributable to financing for which they are not "at risk". Currently, so long as the amount of mortgage financing is reasonable in relation to the value of the property, lenders, including banks and other financial institutions, will provide mortgage capital for rental housing on a non-recourse basis. Requiring that investors forego the security of such non-recourse financing and assume a risk of loss of this magnitude will substantially increase the cost of the capital invested in rental housing. This is an unnecessary burden to place on a vital national resource. At least where the lender is a bank or other third-party, providing independent assurance that the value of the property is sufficient to support the amount of the mortgage financing, the additional capital cost which would result from the increased risk required of investors does not serve any economic purpose.

Renter households have only approximately one-half of the median income of homeowner households. These families cannot afford the substantial increases in rent necessary to enable rental housing to compete with other forms of real estate investment on a purely cash flow (level playing field) basis. Accordingly, the Congress has always seen fit to provide tax benefits to investors in housing in addition to those available for other forms of real estate investment. Without some differential in tax incentives or some other comparable subsidy, housing cannot compete for private capital with other forms of real estate investment. Quite simply, commercial tenants can afford higher rents than the low or moderate income families who comprise the rental population.

As noted above, unlike investors in other forms of commercial real estate, investors in rental housing can now utilize the 175% declining balance method of depreciation under ACRS without forgoing the benefit of capital gain on a disposition of their investment. Additional tax incentives are provided to investors in rental housing to the extent that such housing is set aside for lower income tenants. If 20% (15% in targeted areas) of the units of a rental housing project are set aside for families of low or moderate incomes (i.e., 80% of the area median), obligations issued by a local housing authority to provide mortgage financing therefor will be tax exempt. Further, capital gain benefits, rehabilitation tax credits, and construction incentives are now available with respect to those units set aside for lower income families. The President's tax proposal, however, would eliminate all Internal Revenue Code incentives for housing production.

Essentially, there are three components to the current investment return on rental housing: the actual cash return from rental income; the tax benefits attributable to the investment, and the possible capital appreciation. Investors in rental housing generally accept a 6-8% cash return on equity because of the additional investment return generated by the tax benefits available under current law and the possibility of capital appreciation. The President's tax reform proposal, however, would dramatically curtail these latter two components by eliminating both the investor tax benefits and the capital gain treatment of the appreciation. Accordingly, investors in rental housing can be expected to demand cash rates of return at least equivalent to the 12-13% now demanded by arms-length mortgage lenders. As noted above, the Harvard/Wharton Study estimates that by 1991, the cost of capital invested in conventionally-financed rental housing under the President's proposal would increase by approximately 44% more than under a continuation of current law. Further, the Study predicts that the 20%-30% of all rental housing production which is now financed with IDBs will cease entirely.

Due to the anticipated decline in rental housing production and an increased demand therefor occasioned by the higher cost of homeownership (also resulting from enactment of the President's proposals), the Harvard/Wharton Study estimates that by 1991 rents will have increased by 20-24% more than under a continuation of current law. Because most low and moderate income families pay more for housing than they do in taxes, these drastic increases in their housing costs will more than offset any savings to these families from enactment of the President's tax reform proposals. For example, a two-earner married couple making less than $25,000 a year could expect a tax savings of less than $100 a year under the President's proposal; however, the rental housing costs for such a couple, assuming only a modest 10% increase in rents, would increase by $350-$600 a year -- up to six times their tax savings. Further, these rent increases will result in the successive displacement of the lowest income tenants by more affluent families seeking affordable housing. Thus, any scarcity in rental housing will hit hardest those least able to pay.

Finally, in addition to eliminating the tax incentives which have contributed to the production of affordable rental housing since 1981, the President's proposal would penalize investors who responded to those incentives in the past by requiring an arbitrary and unfair recapture of up to 40% of their post-1979 accelerated depreciation deductions. According to economic forecasts, owners of existing rental housing are already disadvantaged under the President's proposal because their investment in housing will lose a substantial portion of its value. The new recapture tax would doubly penalize these owner/investors by retroactively revoking a portion of the tax incentives on which they reasonably relied. Further, and perhaps most significantly, retroactively increasing the tax burden on these investors could affect the willingness of future investors to respond to deliberate incentives in the Code. The investors who bear this recapture burden will surely think twice before trusting in other federal tax incentives for the production of our country's most basic services.

When dealing with any major legislative reform such as the President's proposal, the Congress must anticipate its effects on the lives of ordinary Americans. It is the responsibility of the Congress and of this Committee to take into consideration the potential impact of any legislation which threatens our broad-based necessities, such as housing, and not to undertake any legislative initiative without full understanding of what that impact will be. This is not a question of whether or not we are going to add an infinitesimal amount to the cost of a luxury item; this is a question of basic needs. In the past, Congress has recognized this type of necessity in its consideration of energy incentives and of our need to guard against a critical shortage in one of our basic resources. Housing is no different. If any legislation is to have a major impact on the cost of housing, that fact should be known to this Committee and to the American public.

It is an accepted fact that the cost of rental housing will rise under the President's tax reform proposal. Also, it is becoming obvious that the cost of home ownership will rise for many Americans. Economists estimate that two-thirds of the families of this country will have their housing costs affected to such an extent that their housing cost increases will exceed any tax savings to be realized under the President's tax reform. The Congress must face the fact that the standard of living of the American people would be seriously jeopardized by such a proposal and that major adjustments will have to be made in people's use of their financial resources as a result. This problem, already facing low and moderate income families, will be extended to most Americans under the President's proposal by an unavoidable increase in their housing costs.

The **Chairman**. Mr. Payne.

STATEMENT OF LEWIS F. PAYNE, JR., CHAIRMAN, WINTERGREEN DEVELOPMENT, INC., WINTERGREEN, VA ON BEHALF OF THE AMERICAN LAND DEVELOPMENT ASSOCIATION

Mr. **Payne**. Mr. Chairman and members of the Committee, I am pleased to appear today on behalf of the American Land Development Association to testify concerning the recent tax proposals. My name is Lewis Payne. I am the chairman of the board of Wintergreen Development, Inc., the developer of the Wintergreen community located in the Blue Ridge Mountains of Virginia. I regret that Mr. Henkel is unable to attend our hearing today. The American Land Development Association represents leading national and international companies that develop and finance recreational resort and residential real estate. The American Land Development Association has engaged leading experts to perform research, including Data Resource, Inc., and Economic Research Associates, to help us draw our conclusions. We are primarily concerned about two issues regarding the tax reform proposal. The first of these is the limitation of interest deductibility. A study that was recently concluded by Data Resources states that the cost of enactment of the tax reform proposal to the U.S. Treasury is $0.92 billion per year each year for the next 10 years. This is due to lower revenues, loss of jobs, and loss of local taxes. Further, we are concerned that the proposal is unfair. We have also determined that the average family income of second-home buyers at the time they made their purchase was $38,000. It seems then that tax reform most affects the middle income purchasers who most need to finance their real estate purchases. Also, we are concerned about the fairness of someone being able to deduct his primary home interest, whether that primary home is as much, say, as $1 million, while other families are unable to deduct a modest ordinary home plus a modest second home interest payment. Our second concern relates to the proposal to tax loan proceeds by the pledging of receivables in our industry. First, this is apparently unprecedented in that the Internal Revenue Code has never attached loan proceeds, but secondly, this affects our industry in that the way we do our business is by pleding our collateral—often our only collateral—which are receivable with recourse to the developers, in order to generate funds to complete our projects. This would be very difficult, if not impossible, if these proceeds were taxed. Now, I have had the firsthand experience. I am in the development business, and since November, I have had the firsthand experience of seeing what tax reform perhaps will do to our industry. The sales in our community, Wintergreen, have been off substantially since this was first discussed in November. In the month of February, for instance—normally a big sales month for us, when we normally expect $2 to $3 million in condominium real estate sales—this year we had none. And this causes great concern for us and our community and our company, but also a great concern is for our larger community, which is the Nelson County community of Virginia. This is a small rural county which very much depends on Wintergreen because of its tax basis and because of the employment. We pay 40 percent of all the real estate taxes in Nelson County, and we are the largest employer, employing 600 people. The next largest employer employs less than 100. It is apparent to us that, to the extent that our business is substantially affected, so is the local economy that we feel very responsible for. And I think the Nelson County community is not unique in this country in that there are many rural communities such as Nelson County where second homes and tourism play such a large part of their overall economic base. We feel strongly that the tax reform as it is currently proposed would have an impact on many of those communities. Those communities also happen to be the very communities where the people are the least mobile and less likely to, one, go to other places to find jobs and, two, they are least able to attract new industries because of their lack of infrastructure and so forth. So, we would ask you today—the American Land Development Association—to consider our comments, both written and spoken, as you proceed with your review and analysis of the proposed Tax Reform Act. Thank you.

[The prepared written statement of Mr. Lee H. Henkel, Jr. follows:]

Statement
of
THE AMERICAN LAND DEVELOPMENT ASSOCIATION
to
The Senate Finance Committee
on
The President's Tax Reform Proposal
by
Lee H. Henkel, Jr.

JULY 16, 1985

American
Land
Development
Association

". . . serving the resort-recreational real estate and community development industries."

5th Floor • 1220 L Street, NW • Washington, DC 20005 • Phone: (202) 371-6700

ALDA CONGRESSIONAL TESTIMONY

Mr. Chairman and members of the Committee, I am pleased to appear here today on behalf of the membership of the American Land Development Association ("ALDA") to testify regarding certain of the proposals contained in the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (the "President's Tax Proposals"). My name is Lee Henkel, Jr. and I was appointed by the President and served as Chief Counsel, Internal Revenue Service during 1972 and 1973. I am now Chairman of the Board of Sands Investment, a diversified recreational real estate company, and am Senior Tax Partner in the law firm of Troutman, Sanders, Lockerman & Ashmore.

ALDA represents leading national and international companies that develop and finance recreational, resort and residential real estate, including vacation homes, condominiums, resort timesharing, planned unit developments, new and retirement communities, mobile home parks and campgrounds. Its members range from small, privately held development companies to real estate development subsidiaries of major corporations and lenders.

ALDA has engaged leading recognized experts to perform research studies to support our testimony. Data Resources, Inc. (D.R.I.), Economics Research Associates (E.R.A.) and the Scott Company (a consulting firm specializing in management consulting for the recreational real estate industry) have supplied us with demographics, projections and statistics which form a strong basis for and bolster our conclusions.

Before moving into the body of our testimony, I would like to bring to the Committee's attention our most salient conclusion. D.R.I. projects that implementation of the overall tax reform proposals would result in a $.92 billion revenue loss to Treasury per year for the next decade due to depressed activity in the second home/recreational real estate sector. (See Appendix A). This is in direct contradiction of Treasury projections that the interest limitation and other real estate provisions would be a net revenue gainer.

Although numerous provisions in the President's Tax Proposal would adversely affect and in our view unfairly impact recreational real estate, we are particularly concerned about and opposed to two specific provisions:

I. The proposal to limit the deductibility of interest, i.e., interest incurred to acquire assets, such as a second home or other interest in recreational real estate.

Our analysis of this provision leads us to conclude the following:

* This proposal is fundamentally unfair to millions of middle income American families because it will inhibit their ability to purchase recreational real estate and in general increase the cost of family recreation.

* This proposal will retard economic development, job creation, and growth, particularly in undeveloped rural communities.

* This proposal invites new tax avoidance schemes which will wrap big ticket consumer items like second homes and loans for college tuition into primary residence mortgages.

* It is inherently unfair to draw tax distinctions between various types of residences and property.

II. Our second area of concern is the proposal to tax the loan proceeds obtained by pledging installment obligations. In our industry, developers use hypothecation financing to secure funding for infrastructure such as roads and sewers, amenity packages, and initial employee and marketing costs.

Our analysis of this provision leads us to conclude the following:

* This proposal would be the first taxation of loan proceeds in the history of the Code. Unlike other forms of financing, hypothecation proceeds are loans with recourse to the developer.

* This proposal would cause radical disruption of the financing of the recreational real estate/resort industry. It undermines the financial stability of a large share of the industry, thus jeop-

ardizing the value, security, and actual utilization by the millions of present owners of condominium timeshares, camping memberships and lots.

* This proposal discriminates against and thus unfairly hampers the ability of businesses whose primary assets are installment receivables to obtain loans. In most cases in our industry, installment receivables constitute the only assets acceptable as collateral to lending institutions.

INTEREST LIMITATION PROPOSAL

Consumer interest has been deductible, without limitation, since the inception of the federal income tax. The Sixteenth Amendment empowering Congress "to lay and collect taxes on incomes" became effective on February 25, 1913. Within a few months, Congress passed the Revenue Act of 1913, imposing a "normal tax" of one percent (1%) on the net income of every citizen of the United States. Section II(B) of that Act provided that in computing net income for the purpose of the normal tax, there would be allowed as a deduction "all interest paid within the year by a taxable person on indebtedness." Since that time, every federal income tax act passed by Congress without exception has contained a similar provision.

IF ENACTED, THE PROPOSAL WOULD COST TREASURY BILLIONS OF DOLLARS IN LOST REVENUES

D.R.I.'s study (Appendix A) analyzes the impact of the interest limitation proposal and new depreciation schedule on tax receipts. D.R.I.'s analysis demonstrates second home and recreational real estate demand are extremely price sensitive and that the interest limitation proposal will have a "depressing effect on the economy and federal tax receipts." D.R.I.'s cost/benefit analysis of the tax proposal's economic impact is that it will depress both housing activity and government tax receipts. D.R.I. predicts implementation of the interest limitation, together with the overall tax reform plan provisions, will generate a whopping "revenue loss from weaker activity." "The cost to the government in receipts would be about $9.2 billion over the next ten years resulting from depressed activity in the second home/recreational real estate sector."

THIS PROPOSAL IS UNFAIR

A. The Proposal Benefits the Rich at the Expense of the Middle Class

Section 163(a) of the Internal Revenue Code of 1954, as amended, (the "Code") currently provides a deduction for "all interest paid or accrued within the taxable year on indebtedness." Although other Code provisions limit or deny interest deductions for certain types of indebtedness, all interest paid or incurred to acquire personal assets is deductible in full, as it has been since the inception of the federal income tax 72 years ago.

Limiting the deductibility of consumer interest unfairly discriminates against taxpayers who must borrow to pay for personal assets, goods and services in favor of taxpayers who can pay for similar assets, goods and services with cash and who need not incur any interest expense as a part of their acquisition cost.

ALDA commissioned the Scott Company to conduct a national survey to determine the composition of second home owners. Contrary to popular myth, the survey concluded that average second home/recreational real estate owners are from moderate income wage earner households. The total average purchase price for second homes and other forms of non-principal residential real estate (hereinafter non-primary real estate) as reported by the survey's respondents was $42,200. 52.7% or an estimated 3,000,000 persons nationwide reported purchases of less than $25,000. The average survey respondent reported an estimated household income at the time of purchase of $37,900 with a current estimated household income of $47,000. (Appendix B).

In short, the non-primary real estate market is truly comprised of America's middle class. It is this middle class who loses if the proposal is passed.

The President's proposal to limit the deductibility of consumer interest, however, would favor the taxpayer who doesn't have to borrow to acquire a personal asset, such as a vacation home or timesharing unit, at the expense of the taxpayer who does. No one knows for certain precisely why every Congress has from the beginning permitted deductions for interest payments. It would not be difficult to speculate that the reason has to do with the general feeling that one who must borrow to acquire or carry assets incurs a very real cost in borrowing and should not be taxed without recognition of that fact. If financing costs were felt to be real and substantial enough to merit a deduction since 1913 when rates were two or three percent per annum (simple interest), why should Congress now eschew and limit deductibility at compound interest rates of 13% (and higher)? The proposal bills itself as one of fairness. What could be more unfair than to penalize and discriminate against the have nots in favor of the haves?

Traditional personal tax deductions stem from the general feeling in Congresses of all compositions that it is unfair to tax similarly situated taxpayers differently. Where one taxpayer has the full use of his income but a second is required or desires to expend his on such things as doctors' bill, real estate taxes, carrying costs or charitable contributions (the so called big 4), Congress has traditionally felt it unfair to ignore their after expenditure position in taxing them. The theme of federal taxation has long been that no one should be taxed on (after expenditure) dollars he doesn't have. Where John D already has the dollars in his pocket to buy with cash, but John Q doesn't, shouldn't John Q at least be able to deduct his finance costs so that after each effects his purchase transaction, John Q is not out both the interest and the tax?

Further, what happens to the cost of assets beyond the cash reach of John Q, but well within the cash grasp of John D? Obviously, where John Q doesn't have the cash to compete in the marketplace with John D, unless John Q can make financing assisted purchases, John D can pay a lesser price. Should we penalize John Q with the resultant (even if unintended) windfall to John D? If we do, we produce the ironic result that those who can't compete in the all cash market help to drive down costs for those who can. The interest proposal would result in the lower and middle classes subsidizing the upper class in direct contravention of the principles and ideals of progressivity long held in our system of self assessment taxation. The irony and unfairness of such a result is palpable.

Factored into this is the mechanical problem of discrepancy between the taxpayers with cash and those without inherent in the proposal. As the proposal is currently written, interest subject to the limitation would be deductible only to the extent of $5,000 plus a taxpayer's net investment income. For purposes of the proposal, the term "net investment income" means the excess of investment income over investment expense. Code §163(d)(3)(A). The Code defines "investment income" as gross income from interest, dividends, rents and royalties.

In other words, where you have two households earning identical amounts, where one works for a living and earns his income exclusively from salary and the other derives his income entirely from passive sources, the proposal would prefer the latter to the former.

By way of example, suppose "A" earns $30,000 as wage income and "B" earns $30,000 in net rents from a building left him by his father. "A" has a $[illegible],000 deductible interest limit and "B" has a $35,000 deductible interest limit!

The proposal's unfairness becomes much more evident when its treatment of the rich is examined vis a vis the balance of society. Whereas the wealthy have passive income sources, the poor and middle class generally don't. Why should Congress deliberately prefer those with passive income sources to those without? Should the wealthy be subsidized by the nonwealthy? Doesn't the whole notion of preferences for those with passive income sources fly in the face of the ideals of progressivity which the proposal's tri rate structure seeks to achieve?

As a practical matter, the proposal, if adopted, would permit an unlimited interest deduction to taxpayers with unlimited net passive sourced income and at the same time severely restrict deductibility of interest by wage earners. The mechanics of the interest limit proposal increases the disparity in treatment between the haves and have nots underscoring and reinforcing an undesirable social policy. It makes little sense to limit consumer interest deductibility at the expense of the have nots. They need not subsidize the tax deductions of the wealthy.

For years Congress has deliberately attempted to help those who do not have cash compete with those who do. The perpetual existence of the interest deduction itself bears testament to this. We have long been guided by the instinct that it is only fair to attempt to put the non-cash buyer on an equal playing field with his cash counterpart by providing an interest deduction. The proposal presents a radical departure from conventional tax and social policy.

B. The Proposal Unfairly Dashes the Expectations of Existing Owners

Further, the proposal is unfair to and penalizes existing owners of property because it invalidates, abrogates and frustrates the expectations they held at the time of purchase. When those of us who purchased recreational real estate, cars, etc. on credit made a purchase decision, we did so on the basis that we could resell our big ticket items intact. The proposal eliminates a substantial part of the asset purchased when it so severely restricts the deductibility of interest. People buy many constituent parts when they buy big ticket items. They purchase the item, the financing, and the carrying cost tax deduction. If an existing property owner sells his property and can't pass on a constituent part of what he purchased, the price he receives reflects this and is diminished thereby. An existing property owner's expectation at the time of purchase is frustrated by legislation he could never have foreseen and can't be deemed to have foreseen. Why punish such a taxpayer? When this unfairness is added to the decline in overall real estate values which will occur as a direct consequence of the the proposed bill, a very undesirable synergy occurs.

THE PROPOSAL RETARDS GROWTH

A. The Proposal Will Retard Growth On A Micro-Economic Level

Enactment of an interest limitation provision would cause major economic dislocation for those who can afford it the least, American labor. To verify this contention, the ERA study conducted in two communities highly dependent on second home development graphically illustrates the devastating impact the proposal will cause on such local economies.

Areas of concentrated second home/recreational real estate development are typically located in isolated, rural areas of the country. Communities dependent upon such resorts are numerous. Nationwide 329 counties had at least 20% of their housing stock in non-primary houses. (Appendix C). Typically, there are no other industries located in these areas. For example, in Beaufort County, South Carolina, the second home and recreational real estate industry will provide approximately 70,245 jobs over the next 10 years. (Appendix C). Calculating a decline in the second home market of as much as 35% as a result of implementation of the President's tax reform proposal (including the interest limitation provision), D.R.I. estimates loss of 15,000 construction jobs per year for the next ten years. In addition, should prospective owners suffer the entire increase in ownership costs, demand for second homes would fall immediately by 296,000 units and 7,000 units perpetually, or 36,600 units per year for 10 years. This is 35% of the second home construction market. (Appendix A).

In Nelson County, Virginia, Wintergreen Resort accounts for the county's largest single source of employment. Those who are employed either directly or indirectly by Wintergreen work as carpenters, plumbers, refrigeration (heat and cooling) contractors, surveyors, brickmasons, excavators, helpers, apprentices, etc. They are entirely dependent upon sales in the recreational real estate market for the survival of their jobs. These laborers do not possess other skills necessary to find job opportunities outside of their field, nor does Nelson County offer a range of job opportunities. As a result, these laborers would have no choice but to relocate.

The Scott Company survey at page 26 reveals that 81% of the respondents (owners of real property other than their residences) stated that their future second home and recreational real estate investments would be curtailed if the Treasury proposal were enacted! To a community like Nelson and Beaufort Counties, such an eventuality would spell catastrophe. Jobs of workers would be lost. Those least able to contend with the economic dislocation inherent in the interest limit proposal would be most adversely affected. It is no answer to a Nelson or Beaufort County carpenter that the proposal may encourage high-tech jobs in the Silicon

Valley. A carpenter who builds recreational units simply would be out of luck, wholly unable to cope and bereft of gainful employment in his home county. Should he be made to bear the brunt of the economic dislocation inherent in the proposed interest limitation? Will the dislocations caused by the proposed interest limit really have been worth the price, especially to those who must bear the brunt, those who are least able to pay the price?

B. The Proposal Will Retard Growth on a Macro-Economic Level

Further, what will happen to the economy as a whole when the incentive to purchase big ticket items over time is virtually eliminated or at best reduced substantially? What can be predicted is that a tight and unprecedented cap on such interest deductibility will retard demand and constrict the economy.

As a revenue matter, D.R.I. tells us the overall depressant effect of the President's proposal on the second home market could result in a net loss to the U.S. Treasury of as much as $.92 billion. If this occurs Congress will have orchestrated both an economic slowdown and at the same time a revenue loss -- a congressionally orchestrated stagflation.

It should be further noted that while funds that are not put into housing will go elsewhere in the economy, namely to consumption or corporate investment, that a large fraction of this other spending will go overseas. Because housing is a leveraged investment and construction is a labor intensive industry that must use domestic inputs, construction, provides more "bank-for-the-buck" for the U.S. economy than alternative spending.

REAL ESTATE IS THE QUINTESSENTIAL AMERICAN INVESTMENT

The interest limit unfairly hurts the entire real estate industry and its consumers. It may be that John D. can count big oil, and stocks and bonds among his portfolio of assets, but John Q. can't. John Q's piece of the rock is almost always real estate. The American dream is to own real estate. It is the one investment that mainstream America can understand. Unlike stocks and bonds, it is not intangible. One need not utilize the services of a C.P.A. or other expert in arcane investment strategies to read real estate's balance sheet. Real estate can't be manipulated like stock. Real estate's value does not constantly change, in fact it is the one investment which has been constantly encouraged and dependable since the inception of the tax law in 1913.

For the average American, real estate is his one unique, comfortable and dependable investment. Wall Street may rely on debentures and other sophisticated vehicles to account for its wealth, but main street relies on real estate. The average American is suspect that anyone makes money in the stock market over the long haul. He has no doubt, however, about making money in real estate. His experience in real estate has convinced him of its dependability over the any run, long or short.

To prove this point, even the proposal would not limit deductibility for primary residence interest. What is the qualitative difference between interest paid on a primary residence and interest paid on a second home or other recreational real estate? Interest is interest is interest. Should Congress be so anxious to limit the American dream to only one house for our wage earners and forget entirely about the salutary benefits of recreation? Why drive up the cost of recreation for the average American? As pointed out above under the proposal, the wealthy can still fully deduct their second home expense. The poor still won't be able to afford to purchase a primary residence. Under the proposal, the middle class gets the ax. They will be the only ones unable to deduct their interest. Is it prudent to increase the costs of recreation for those who need recreation the most -- American's wage earners?

IF ENACTED, THE PROPOSAL WILL RESULT IN ENORMOUS COMPLICATION

Finally, if the proposal is enacted, there will be resultant complication and use of complex tax strategies to ameliorate inherent unfairness. Congress need not pass a 1985 Tax Lawyers, Accountants and Banker's Relief Act. (Appendix D).

It takes no financial genius to see that where all first home mortgage interest is deductible and there is a tight cap on second home or other consumer interest, that all one need do is disguise his big ticket purchase so that he can take the greatest deduction possible to reduce his costs. For example, if "A" purchased a home for $50,000 years ago which is worth $100,000 today and he desires to purchase a second home or another big ticket item, he has two choices. He can purchase the property on credit and pay his interest without full benefit of a tax deduction or he can borrow against the equity on his first house (no rational lender would advance him more than its fair market value. Payments of interest on such a primary residence loan under the proposal are fully deductible), apply the proceeds to the desired purchase and deduct all interest thereby reducing his cost of purchase. No rational buyer would willingly choose the former method over the latter. In essence, if the proposal passes, all owners of first homes will be counseled by their tax professionals to continually keep their primary residences mortgaged as high as possible so cash can be freed up and payments of interest will be deductible without limit. Should Congress encourage such complicated tax strategies? Should Congress encourage keeping primary residences always mortgaged up to fair market value? Further, the only parties to benefit will be the lenders and their professionals who paper transactions.

It is also readily apparent that differentiation between interest deductibility on first and second homes will in many cases inure to the benefit of the wealthy at the expense of the middle class. If Mr. "A" has a $1,000,000 primary residence, he may deduct all interest paid thereon.

However, Mr. "B" may own a $50,000 primary residence and purchase a $30,000 second home without benefit of an interest deduction. Why should the extravagance of a primary home be encouraged while the camping pad of the R.V. owner isn't? What makes owning a $1,000,000 home more socially desirable than owning two modest dwellings, one of which is used for recreation by a wage earner? There appears to be no rhyme or reason to the proposal. It will expand the deficit, encourage complicated tax strategies, foster unfairness and promote economic contraction. The arbitrary limit on interest would create economic dislocation (unemployment) for those least able to cope. Should we risk proven growth, unprecedented dynamic economic expansion and consumer satisfaction for what will be a billion dollar net loss of dollars to Treasury? The recreational real estate industry strongly feels we should not.

The self-admitted purpose of the proposal is to "curtail tax shelter abuses." It is obvious that the recreational real estate industry has been ensnared in a net far too broad. In no sense would it be fair to categorize the recreational real estate industry as being part of "tax shelter abuse."

PART II

GAIN SHOULD NOT BE RECOGNIZED ON PLEDGES OF INSTALLMENT OBLIGATIONS

FACTS

Generally developers who sell timeshares or associated recreational real estate products sell to consumers who are not able to purchase for cash. Typically these products are sold in return for a nominal cash downpayment and delivery to the developer of a purchase money promissory note (installment obligation). The purchase money note is payable in installments over time. The noteholder (generally the developer) has the option to hold the note and await his time payments over the normal course under the terms of the note, sell or otherwise dispose of the note or borrow money at some discount to the face amount of the note (advance rate) using the note as collateral.

The recreational real estate developer generally has substantial obligations to furnish common area facilities (i.e., swimming pool, infrastructure, including landscaping, road and pathways, and entertainment areas) plus "up front" employee and marketing costs which a normal residential or commercial builder simply does not have. As a result, recreational land development is initially a negative cash flow business.

Typically the recreational developer (timeshare or otherwise) must expend substantial dollars to complete a project even after he has made sales. The normal builder is generally paid for his work upon sale. Further, whereas the after sales work of the normal builder is minimal i.e, of the touch up or punch list variety, all of which is paid for by an escrow account established at closing, the recreational timeshare, (or other) developer has substantial and costly post sales work to complete for which there is no escrow money. Because of this, the recreational real estate developer is truly unique.

Because of his unique need to pay for a project's common expenses prior to the time he has a full sell out, the recreational developer is required to expend funds immediately to meet his project commitments. He can only recoup these costs from future sales. Our developers sell land to customers and use general subcontractors to develop projects. They have few assets apart from their purchase money sales contracts.

Typically the recreational real estate developer does not have the cash on hand to pay for his project expenses. He must borrow. Generally the only asset the developer has to collateralize a loan are the installment sales contracts the developer acquires as a consequence of prior sales. The Proposal seeks to impose a tax where a developer borrows using his purchase money notes as collateral. We believe such a proposal is unfair and its rationale unwarranted. Further, it would devastate the typical timeshare or other recreational real estate developer in our industry.

The Law

Code §453 currently provides that income from installment sales is reported as payments are received unless the taxpayer otherwise elects. Generally, an "installment sale" is one where at least one payment is received after the close of the taxable year in which sale occurs. Code §453(b)(1). The gain recognized for any year is limited to that portion of the installment payment(s) received in the year which represents profit. In other words, that portion of the installment payment representing the Seller's cost or basis is not taxed but is treated as a nontaxable return of capital.

Code §453 was enacted to alleviate liquidity problems that would obviously arise if a taxpayer were required to pay tax on a sale without having first received his sales proceeds.

Where a seller disposes of an installment obligation, the tax that has been deferred on the installment sale generally becomes due. Code §453B. This is so because such a sale is an asset sale subject to normal rules of taxation. Where a taxpayer does not dispose of the installment obligation but rather pledges that obligation as collateral for a loan, there is no incidence of tax because there has been no disposition. The Proposal seeks to impose tax upon a borrower who pledges his installment obligations as collateral security for a loan at the time the loan is made. The proposal "reasons" that there is no good reason to defer tax on an installment sale once the installment obligation is pledged as collateral for a loan and the taxpayer has cash in the form of loan proceeds from which he can pay tax. The Proposal simply ignores fundamental facts and well recognized law in coming to its startling conclusion.

THE PROPOSAL TO TAX LOANS IS BOTH UNFAIR AND UNPRECEDENTED

Loans do not now constitute, nor have they ever constituted taxable income. That proposition is fundamental to federal tax law. While the Code taxes"income from whatever source derived" (Code §61) it specifically does not tax now nor has it ever taxed loans. James v. U.S., 366 U.S. 313 (1961). "Income from whatever sourced derived" means accessions to wealth clearly realized and over which a taxpayer has complete dominion and control. James, supra and Commissioner v. Glenshaw Glass Co., 348 U.S. 426. A gain constitutes taxable income only when there is no consensual or concommitant obligation to repay. James, supra. Once a repayment obligation is present, there simply is no taxable income. It is palpably wrong to impose a tax on loaned proceeds over which a taxpayer has only a conditional right and an absolute obligation to repay. Taxation has never, ever occurred under such circumstances.

No taxpayer should be taxed until and unless he actually has something upon which a tax can be imposed. In other words, there is and should be no income tax until a taxpayer receives payment "for keeps". Where a lender loans proceeds to a borrower for consideration i.e., repayment of the loan plus interest, it would be unprecedented for a taxable event to occur. The loan must be repaid. The proceeds are not the borrower's for keeps. He only has temporary and conditional use of the borrowed funds. A lender can accelerate or recall his loan upon the occurrence of one of a number of contingencies. If repayment is not swiftly made, a Court will require repayment plus collection costs. For this reason it is simply unprecedented and illogical to tax loans proceeds.

Furthermore, numerous ancillary questions arise. What happens upon repayment? Should taxpayers who repay loans get deductions in the years of repayment and if so, does this not unnecessarily complicate their lives and the jobs of IRS auditors? Such a misguided policy (of taxing loans) offends traditional notions and precepts of tax law for obvious reasons. We simply don't tax until the taxpayer receives income for keeps. We never have. We never should.

RECREATIONAL DEVELOPMENT LOANS ARE MADE WITH FULL RECOURSE, FOR SHORT TERMS AND ARE DIFFERENT FROM BUILDER BONDS

It is true that but for Code §453 a taxpayer would be required to recognize as income the fair market value of whatever he received as consideration for his sale. The proposal recognizes that Code §453 is essential to prevent abuse by government i.e., imposing and collecting a tax before there is cash realized. In fact, in 1980 Congress revised and liberalized Code §453 requiring that it be used to report installment sales (except where a taxpayer otherwise elects) without regard to old mechanical rules i.e., no more than 30% down payment in the first year, etc.

The Proposal does not propose a change in Code §453 implicitly recognizing the necessity of that Code section. Instead, the Proposal seeks to alter Code §453B to tax selected loan proceeds because in certain cases the Proposal suggests the possibility of taxpayer abuses (i.e., builder bonds).

The recreational real estate industry finds itself trapped in an overly broad net for no apparent reason. Builder bonds are quite different from pledged receivable loans. Loans to recreational real estate developers typically and are made with personal recourse to the borrower. This means that when a loan is made to such a developer using his purchase money sales notes as collateral where there is a default in payment by either the developer or his purchaser, the developer is on the hook personally for repayment to the lender. Builder bonds, especially those packaged and sold by Wall Street, are generally nonrecourse. This distinction is critical and one with a very real, theoretical and pragmatic difference. This is the reason recreational real estate pledged receivable loans should not taxed nor viewed as builder bonds.

Further, loans to recreational real estate developers are typically short term loans as opposed to the long term typical of builder bonds. The distinction between recreational real estate loans and builder bonds is one with a meaningful, substantive difference.

The Proposal's rationale supporting taxation of loan proceeds under certain circumstances is premised on the grounds that such deferral is permitted even where the buyer's note is "secured by a bank letter of credit so that the transaction is essentially riskless for the seller." Proposal p. 209. If Congress makes the unprecedented decision to tax loan proceeds at all, it is submitted that such decision should be limited to the situation set forth above as the grounds for the Proposal to wit where the borrower (developer) is not personally obligated for repayment of the borrowed amount and where he is assured by a bank letter of credit or the like that he will never have to pay.

Only in such case, is the Proposal's underlying assumption arguable i.e., conditional possession of proceeds being synonymous with no strings attached ownership. Where a borrower has personal recourse on a loan or where he is not guaranteed his purchaser's payments will be made in all events, he does not have his loan proceeds without strings and should not be taxed.

It makes a great deal of sense to distinguish between the case where proceeds are borrowed and must be repaid by the borrower and the case where no repayment need come from the borrower. The cases are so distinguishable substantively that they compel different tax results. Otherwise, the Code would equate the borrower with no strings attached loan proceeds with the borrower who is on the hook until the loan is repaid in full with interest, two situations very different in both form and substance, situations that on their face and even to the unsophisticated are poles apart. The Code should not equate conditional possession with unconditional, unfettered ownership. Such equation is absurd.

The Proposal argues (at p. 209) that pledged collateral loans should be taxed because the pledge of an installment note after sale is substantially identical to a purchaser's assumption at the time of sale of a sellers' preexisting acquisition or development loan on property. The Proposal correctly states that assumption of such a loan by the buyer is treated for tax purposes a payment to the seller in the year of assumption.

The interesting aspect of such analysis is that it does not differentiate between an assumption (which takes the seller off the hook) and the continued existence of a recourse loan to him on which the seller continues to be liable for repayment. Using the Proposal's own example in the case where the seller borrows using the underlying property as collateral and he is not taken off the hook by an assumption, there is no payment made or deemed to be made in the year of sale under existing law.

It is not intellectually honest to compare an assumption of indebtedness on property to a pledged receivable installment obligation unless the installment obligation does not bear personal recourse and there exists a guarantee to the seller that the installment obligation will never have to be repaid by the borrower. Accordingly, we submit that the Proposal is supported only by a false analogy offering a meaningless and erroneous tautology to support its conclusion that pledged receivable loans regardless of their nature should be taxed because they are like builder bonds.

OUR INDUSTRY DESERVES TO BE INCLUDED IN THE PROPOSAL'S EXCEPTIONS

The Proposal provides certain exceptions to the general rule. We submit that if a decision is made to tax loan proceeds there should be an exception for "at risk" loans i.e., those bearing recourse or which are not assured of being paid off by some party other than the borrower. The Proposal's existing exceptions are:

(1) a one-year installment payment;

(2) a one-year revolving credit plan;

(3) a 90-day loan; and

(4) loans by financial institutions secured by a general lien on all the borrower's trade or business assets.

The recreational real estate industry needs to be excepted out for its recourse at risk loans. There would appear to be no valid distinction between a general lien loan to a manufacturer and a pledged receivable loan to a developer. The only factual difference between the two is that whereas manufacturers are fortunate enough to have a stock of assets that

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can be pledged, recreational real estate developers only have their receivables. Those in our industry sell their land to their consumers and typically use outside general and subcontractors to "manufacture" their product. We submit that this difference between our developers and manufacturers do not matter tax wise at all and should not account for the preferred position under the Proposal given traditional manufacturers but denied recreational real estate developers. It is only just that the recreational real estate industry be included in the general lien exception because where installment contracts constitute almost all a developers assets, he is in fact placing a general lien on all his trade or business assets when he pledges his receivables.

IF THE PROPOSAL PASSES IN ITS PRESENT FORM, IT WILL DEVASTATE THE RECREATIONAL REAL ESTATE INDUSTRY

Attached hereto is a projection entitled Tax Consequences of a Sale of Receivables Versus a Hypothecation with three tables prepared by Stuart Marshall Bloch, a senior partner with Ingersoll & Bloch, Chartered, a prominently recognized firm in the recreational real estate field. The attached chart demonstrates how the Proposal would devastate the timeshare, camp resort and land sales developers who pledge receivables as collateral for loans. Mr. Bloch's conservatively estimates that well in excess of one billion dollars annually is obtained by developers in our industry through hypothecation of their receivables. In recent years, the amount of cash available to our developers through pledging receivables has dramatically decreased due to the discount applied by the lenders, the increased costs of money, product, marketing and regulatory compliance. Mr. Bloch's study demonstrates a 10%-15% decrease in cash flow from enactment of the Proposal. Mr. Bloch concludes that when this is added to the developer's other increasing costs, enactment could "sound a death knell to the industry as we know it." Mr. Bloch concludes that "For developers with a modest profit, the Treasury proposal would threaten the continuation of their business altogether."

As previously explained, recreational land development is initially a negative cash flow business (due to significant marketing costs payable "up front"). Recreational land development is absolutely dependent on liquidating receivables to insure necessary cash flow to pay "up front" costs.

In addition, if hypothecation is taxed, consumers will no longer have the benefit of attractive purchase money loans and while lenders and their lawyers will benefit, developers and consumers will be hurt.

It is obvious that taxing pledged receivables loans will constrict business, harm the consumer, devastate the industry and place an unprecedented (taxation of loan) burden on us. Congress should eschew the proposal and will undoubtedly desire to do so once the unfairness is brought to light.

The issue is arcane and accordingly difficult to understand but the evil to our industry and American consumers inherent therein is too dramatic and invidious to ignore. Taxing pledged receivable loans would truly be a dagger in the heart for many in our industry and should be rejected on the above grounds.

DRI Data Resources Inc

APPENDIX A

EXECUTIVE SUMMARY

THE IMPLICATIONS OF THE PRESIDENT'S TAX PROPOSAL FOR THE SECOND HOME MARKET

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Prepared for
American Land Development Association
July 8, 1985

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Prepared by
Data Resources, Inc.
24 Hartwell Avenue
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The President's tax reform plan would alter incentives for many types of economic behavior. Some activities that are currently profitable because of favorable tax treatment will become unprofitable, imposing an unexpected loss. In addition, the plan would reduce national savings by shifting income away from the corporate sector toward the low-saving household sector. Interest rates are the market price of savings, hence a lower supply of savings would necessarily dictate higher post-tax interest rates. The federal deficit expands into the 1990s as the corporate tax increases no longer counter balance personal tax cuts, further driving up interest rates. Therefore neither the static nor dynamic macroeconomic effects of reform augurs well for residential investment.

Data Resources, Inc. (DRI) has been commissioned by the American Land Development Association (ALDA), with James Scott of the Scott Company as project manager, to study the impact of tax reform on the second home industry. We find reform would raise the cost of homeownership generating a negative impact on builders, existing owners, and potential consumers.

The table below illustrates the effect of proposed changes on current and prospective property owners according to owner-occupied or commercial use. Lower marginal tax rates raise the after-tax cost of borrowing to all market participants. The loss of state income tax deductibility raises effective marginal tax rates, somewhat compensating for the lower federal rate. Owner-occupants also lose property tax deductibility, but benefit from a lower capital gains tax rate. Indexation of depreciation allowances, but with a lower depreciation rate, raises costs for briefly held rental property.

Provisions in the President's Tax Proposal that Affect the Second Home Market

	Owner-Occupied	Effect on Costs	Rental Units	Effect on Costs
Current Owners	Lower marginal rate.	+	Lower marginal rate.	+
	Loss of state tax deductibility.	-		
	Loss of property tax deductibility.	+		
	Lower capital gains rate.	-		
Prospective Owners	Lower marginal rate.	+	Lower marginal rate.	+
	Loss of state tax deductibility.	-	New depreciation system.	+
	Loss of property deductibility.	+	New capital gains treatment.	-
	Limited interest deductibility.	+		
	Lower capital gains rate.	-		

The proposed limitation on interest deductibility would depress the market for owner-occupied homes. Using survey data on the income distribution of current and prospective second-home owners we conclude that few current owners, but 15% of the potential market could be affected by this provision. Virtually all of the burden would fall upon middle-income earners without the financial resources to escape the limitation. We see few people actually paying tax under this provision, but the purchase decision of enough individuals would be discouraged or postponed to weaken total market demand.

The net impact of these changes is to initially drive up housing costs for potential buyers of rental or owner-occupied housing by up to 15%. Since existing home prices are determined by the price potential buyers are willing to pay, existing property owners will see their home values decline 5-15%, with the more expensive homes seeing the greatest declines. Undeveloped land values will fall and builder profit margins narrow in an effort to boost customer sales of new units. But these price declines will not fully offset the increase in ownership costs, therefore we expect new construction to fall. Should new home prices fall by 5%, and factoring in higher disposable income from the proposal's tax cut, the demand for second homes will suffer a 115,000 unit decline. Averaging that decline over 10 years, and adding in a perpetual annual loss of 2,700 units, results in a loss in new construction of 14,200 units per year or 14% of the second home market.

These calculations assume a middle ground, that the increased tax burden on real estate is shared between prospective and current property owners. Should prospective owners suffer the entire increase in ownership costs, demand for second homes would fall immediately by 296,000 units and 7,000 units perpetually, or 36,600 units per year for 10 years. This is 35% of the second home construction market.

There are costs to economic growth and the U.S. Treasury from diverting spending from second home construction to consumption or corporate investment. A large fraction of this other spending flows overseas, while homes must be "made in America." Taking account of the big multiplier effect of construction, a 14% decline in the second home market costs the construction industry 5,600 jobs, with a net loss to the economy of 3,600 jobs. The Treasury suffers a $0.36 billion loss per year in tax receipts. A 35% decline in the second home market loses 15,000 construction jobs, 9,000 net jobs, and the Treasury $0.92 billion per year in revenues.

Our study first reviews the different features of the President's Proposal that could affect the second home market. Using the concept of the "user-cost of homeownership," we then derive the effect of each proposal on the effective cost of owning and/or renting property. The ramifications of the implied change in price for housing demand and hence new construction is explored using historical data and regression analysis. The translation of the potential construction decline onto total employment and personal income is found using the DRI Model of the U.S. Economy. We close with a discussion of the potential revenue loss to the U.S. Treasury.

APPENDIX B

THE SCOTT COMPANY

The Scott Company, Inc.
Management Consultants

66 Surfwatch Drive
Kiawah Island, S.C. 29455
(803) 768-0002

EXECUTIVE SUMMARY

Five thousand and two (5,002) property owners were surveyed by The Scott Company to determine potential impacts of Tax Reform on owners of "non-primary" real estate (i.e., residential real estate other than a primary residence). One thousand five hundred and eighty-seven (1,587) survey respondents owned non-primary residential real estate and the following points summarize survey findings:

- Of all types of "non-primary" residential real estate, single family residences represented the highest category with 45.8% of survey respondents owning this type of real estate.
- Most of the survey respondents had purchased their property between 1980 and 1985 with 45.8% of the survey respondents having purchased in this time period.
- Of the alternative reasons for purchasing property, recreational use (43.9%) and investment use (41.4%) were the two highest use categories indicated.
- An increasing tendency to make purchases of property for investment reasons was seen in the group making relatively recent purchases.

- Of those purchasing property for investment reasons, 40.9%, or an estimated 970,000 persons nationwide, had purchased property with an estimated market value less than $46,000.
- Of those purchasing property for investment reasons, approximately 11.7%, or an estimated 280,000 persons nationwide, indicated current estimated household incomes of less than $25,000 per year.
- Eleven and five-tenths (11.5%) of survey respondents indicated that they had purchase property in conjunction with other investors.
- Forty eight and nine-tenths (48.9%) of the survey respondents indicated that they rented their property.
- Of those persons indicating that their property was rented, the average annual rental income was $4,750.
- Of those indicating that property was rented, 75.2%, or an estimated 1,700,000 persons nationwide, indicated that they would raise rental rates if Treasury's proposal were enacted.
- The total average purchase price for non-primary real estate was $42,200. Fifty two and seven-tenths (52.7%) of the survey respondents, or an estimated 3,000,000 persons nationwide, indicated a total purchase price of less than $25,000.

- The average survey respondent had financed 67.8% of the total property purchase price.
- Average monthly principle and interest payments were $470.
- The average term for non-primary real estate mortgages was 16.5 years and the average interest rate was 11.0%.
- The average estimated market value of non-primary residential real estate was $70,500, with non-primary single family residences having average estimated market values of $71,100 and condominiums or co-ops having average values of $95,500.
- The average estimated household income at the time of purchase was $37,900 and the current estimated household income of all survey respondents was $47,000 per year.
- The average age of survey respondents was 50.7 years and approximately 24.6% of the survey respondents, or an estimated 1.4 million persons nationwide, were retired.
- Four hundred and seventy thousand (470,000) non-primary residential real estate units were held by retired persons for investment purposes.
- It is estimated that 80% of the survey respondents would not have planned to sell their property within the next three years, if Treasury had not proposed the tax changes.

- It is estimated that 43% of the survey respondents, or an estimated 2,500,000 persons nationwide, would not have purchased their property if Treasury's interest deduction limitation were in effect at the time of their purchase.
- Based on survey responses, it is estimated that approximately 16% of the survey respondents, or an estimated 920,000 persons nationwide, would be forced to sell their property if Treasury's proposal were enacted.
- It is estimated that 81% of the survey respondents will curtail future investments in real estate if the Treasury proposal is enacted.

APPENDIX C

Economics Research Associates

Los Angeles, California
San Francisco, California
Seattle, Washington
Chicago, Illinois
Boston, Massachusetts
Washington, D C
Ft Lauderdale, Florida

EXECUTIVE SUMMARY

IMPACTS OF PROPOSED TAX CHANGES ON LOCAL ECONOMIES

PREPARED FOR

AMERICAN LAND DEVELOPMENT ASSOCIATION

JULY 1985

PREPARED BY
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EXECUTIVE SUMMARY

Economics Research Associates (ERA) was retained by the American Land Development Association (ALDA) to analyze the economic importance of the second home industry to local economies. Two case studies were conducted to illustrate the economic importance of the second home industry in two different areas.

The first case study focused on Hilton Head Island in Beaufort County, South Carolina. As a second home community, Hilton Head may be characterized as:

- Planned resort community,
- Coastal,
- Above average property prices,
- New and rapidly growing.

In order to study a variety of situations, the Coeur d'Alene area in Kootenai County, Idaho was selected as the second case study area. In contrast to Hilton Head, Coeur d'Alene can be characterized as:

- An older, established vacation home area,
- A mountain and lake setting,
- Moderate property prices, and
- Second home industry which is more thoroughly integrated with a non-resort community.

CONCLUSIONS

Based upon the case studies, several significant conclusions were developed. These are summarized below:

- NON-PRIMARY HOMES REPRESENT A MAJOR COMPONENT OF THE HOUSING INVENTORY:
  - Based on the 1980 Census, 48 percent of all units on Hilton Head Island, and
  - 15 percent of all units in Kootenai County are non-primary houses.
  - On a nationwide basis, 329 counties had at least 20 percent of their housing stock in non-primary homes.
- MANY HOMES BUILT ORIGINALLY AS SECOND HOMES END UP AS PRIMARY HOMES FOR PERMANENT RESIDENTS AND RENTERS.
  - This is especially true of areas similar to Coeur d'Alene which have viable local economies in addition to second home and tourist industries. In Hilton Head, 77 percent of the units are owned by non-residents. Subtracting the 48 percent non-primary units indicates that 29 percent of the units are primary homes owned by non-residents. Most of these were originally purchased as second homes. In Coeur d'Alene, a significant number of persons who were previously visitors or second home owners have chosen to live there permanently.
- OWNERS AND TOURISTS VISITING SECOND HOME/RESORT COMMUNITIES ARE MAJOR SUPPORTERS OF THE ECONOMIC BASE.
  - Dollars brought into the local economy by these seasonal visitors create a multiplier effect in expanding the local commercial economy. For example, approximately 50,000 square

feet of commercial development are supported by each 1,000 second homes. This represents approximately $7.5 million in retail sales.

- SECOND HOMES REPRESENT A MAJOR PROPORTION OF THE ASSESSED VALUATION.
  - Second homes tend to be located in premium environments, and are often more valuable than the average primary home in the area. In 1980, Hilton Head accounted for only 38 percent of Beaufort County's housing units, but 56 percent of the assessed valuation.
- MANY CONSTRUCTION JOBS ARE DEPENDENT UPON THE SECOND HOME INDUSTRY.
  - Case studies indicate that one local construction job is created for every $70,000 in second home construction.
- RURAL COUNTIES OFTEN DEPEND UPON THE TOURISM AND SECOND HOME INDUSTRY TO PROVIDE ECONOMIC DEVELOPMENT AND/OR TO REPLACE DECLINING RESOURCE BASED INDUSTRIES.
  - County master plans have been based on the development of tourism and second-home/resort communities.
- SALES OF SECOND HOMES ARE THE ECONOMIC BACKBONE UPON WHICH MANY RESORT COMMUNITIES ARE BUILT.
  - The sale of second homes is a vital component of most planned resort developments. Without the contribution of second home real estate sales, the overall projects (including hotels, commercial space, golf course, ski lifts, etc.) would often not be feasible.

- **EXPENDITURES MADE BY SECOND HOME OWNERS, GUESTS, AND RENTERS ARE AN IMPORTANT SOURCE OF PERMANENT JOBS.**
  - The number of permanent jobs per 1,000 second homes ranged from about 300 for a regional second home area such as Kootenai County to 750 for a destination resort area such as Hilton Head.
- **SECOND HOMES SUPPORT ROAD, STORM DRAINAGE AND WATER AND SEWER IMPROVEMENTS.**
  - These infrastructure improvements are important to the health and welfare of permanent residents and would not otherwise be economically feasible.
- SECOND HOME CONSTRUCTION IS VERY SENSITIVE TO ECONOMIC CHANGES AND CONDITIONS.
  - During the recession of 1975-76, second home construction fell by 80 percent at Hilton Head.
- SUBSTANTIAL FORWARD COMMITMENTS AND INVESTMENTS IN SECOND HOME COMMUNITIES HAVE ALREADY BEEN MADE.
  - Most projects are long term and the profits (if any) are generally made in later years.
- COMMERCIAL DEVELOPMENT AND AN EXPANDED ECONOMIC BASE CAN FOLLOW INITIAL DEVELOPMENT FUELED BY SECOND HOME/RESORT DEVELOPMENT.
- SECOND HOME LOTS ALSO REPRESENT MAJOR INVESTMENTS AND A SOURCE OF FUTURE CONSTRUCTION ACTIVITY.
  - In Hilton Head, there were 7,066 vacant lots owned by non-residents in 1984. In the Coeur d'Alene area, 70 percent of the lakefront parcels (which have been the most attractive for second home development) are owned by out-of-state residents, and 60 percent of these parcels are still undeveloped.

- **SECOND HOME DEVELOPMENTS OFTEN SERVE RETIREMENT AND PRE-RETIREMENT HOUSING NEEDS FOR INVESTORS AND LOT OWNERS.**
  - Approximately 35 percent of second homes are bought as pre-retirement homes.

IMPACTS OF PROPOSED TAX CHANGES

Separate analyses by Data Resources Incorporated (DRI) and ERA have indicated that the demand for second-home housing will decline substantially due to the proposed tax changes. DRI forecasts that the annual cost of second-home ownership will increase an average of 15 percent and that there will be a net 35 percent decline in second-home housing starts over the next 10 years. On a nationwide basis, this represents an annual decline of 36,600 units. For each of the case study areas, the decline in housing starts would have the following direct impacts over the next ten years:

	Beaufort County	Kootenai County
DIRECT IMPACTS		
Decline in Second-Home Housing Starts	5,040	525
Lost Jobs (man-years)		
Construction	7,310	760
Support	20,790	885
	28,100	1,645
Lost Property Taxes		
From Existing Valuation	$ 7.8 million	$2.8 million
Future Units	24.2 million	3.9 million
	$32.0 million	$6.7 million

These direct impacts would circulate throughout the local economy and, due to this multiplier effect, would cause decreases in primary home construction and further losses in employment and tax revenues. A typical multiplier of 1.5 would lead to the following cumulative impacts over 10 years:

TOTAL IMPACT	Beaufort County	Kootenai County
Lost Housing Starts	12,600	1,310
Lost Jobs (man-years)		
Construction	18,270	1,900
Support	51,975	2,215
	70,245	4,115
Lost Property Taxes		
From Existing Valuation	$19.5 million	$ 7.0 million
Future Units	60.5 million	9.8 million
	$80.0 million	$16.8 million

These impacts are substantial and affect both rapidly growing second-home/resort areas (Beaufort County) as well as older second home locations (Kootenai County).

SUMMARY OF DIRECT IMPACTS OF PROPOSED TAX CHANGES ON BEAUFORT COUNTY

	Over Next 10 Years		
	Without Tax Changes	With Tax Changes	Net Loss
Second-Home Housing Starts [1]	14,400	9,630	5,040
Jobs (man-years)			
Construction [2]	20,880	13,570	7,310
Service & Support [3]	59,400	38,610	20,790
			28,100
Property Taxes			
Existing Units [4]		$(7.8) million	$ 7.8 million
Future Units [5]	$61.0 million	$36.8 million	24.2 million
Total			$32.0 million

[1] Based on build out projections.
[2] At 1.45 jobs/unit. Equivalent to 731 jobs per year.
[3] At 0.75 jobs/unit, cumulative over 10 years. Equates to annual lost employment of 3,780 jobs in 10th year.
[4] Reflect effects of decline in market value of current units, estimated as follows:

Total County Market Value	$4 billion
35% Non-Primary Units	35%
Market Value for Non-Primary Units	$1.4 billion
Decline (@ 8%)	$112 million
Lost Property Taxes (@ 0.7%)	$784,000
Over 10 Years	$7.8 million

[5] At 0.7 percent of market value (average $110,000 before tax changes and $102,000 after tax changes), cumulative over 10 years. Equates to annual lost revenue of $4.4 million in 10th year.

SUMMARY OF DIRECT IMPACTS OF PROPOSED TAX CHANGES ON KOOTENAI COUNTY

	Over Next 10 Years		
	Without Tax Changes	With Tax Changes	Net Loss
Second-Home Housing Starts 1/	1,500	975	525
Jobs (man-years)			
Construction 2/	2,175	1,415	760
Support 3/	2,475	1,610	865
			1,645
Property Taxes (cumulative)			
Existing Units 4/		($2.8 million)	$2.8 million
New Units 5/	$11.1 million	$7.2 million	3.9 million
Total			$6.7 million

1/30 percent of 500 = 150 units per year.
2/At 1.45 per unit.
3/At 0.3 support jobs per second-home unit.
4/4,200 existing units at an average value of $55,500 suffering an 8 percent decline in value with a 1.5 percent tax rate.
5/1.5 percent of new unit market value (estimated @ $90,000) cumulative over 10 years. Annual loss at end of 10 years is $1 million.

APPENDIX D

THE NATION'S HOUSING

Prescription for a 2nd Home: Go With the (Tax) Flow

By Kenneth R. Harney

If you're one of the 10 million Americans who own or want to buy a second or vacation home, you may be interested in Henry Berliner's prescriptions for possible federal tax reforms this year: Go with the flow and keep taking deductions with PIP and IMP.

Berliner is the outspoken, innovative president of a $500 million-asset Maryland savings and loan association that pumps a lot of its funds into mortgages for vacation homes and condos. Rather than being cowed by the Reagan administration's tax-reform proposals sharply limiting interest deductions on second homes, Berliner has created two loan concepts that deal with them head-on.

The first is dubbed PIP, the "Primary Investment Program." PIP seeks to give home owners maximum mileage out of tax-code changes that leave mortgage-interest deductions on owner-occupied, principal residences unscathed while cutting back on deductions for nonprincipal homes. Under PIP, Berliner's S&L will turn your principal residence into a bigger deduction-producer by increasing its total mortgage debt and hand you the money to buy your beach house for all cash.

Here's how it works. Let's say that Congress and the White House cur-

See HARNEY, E30, Col. 1

THE NATION'S HOUSING

HARNEY, From E26

tail the ability of owners of second homes to deduct mortgage interest on their properties. Let's assume also that President Reagan and Congress keep their pledge not to limit mortgage interest deductions for principal residences, no matter how high the deductions go.

How do you afford a vacation home under these tougher tax circumstances? How do you recover at least some of the tax advantages currently provided through interest deductions on second homes, beach condos and ski retreats? Henry Berliner's answer is unequivocal: Shift your mortgage debt to the property that gets preferential tax treatment from the federal government.

Under his S&L's PIP plan, borrowers will be able to raise the mortgage debt level on their principal homes to as high as 95 percent of appraised value. The money that they pull out then will be used to acquire a new or resale second home at a cash price.

The total combined debt outstanding on the first and second homes won't be increased this way, Berliner noted. "The only thing that changes is where you're generating your interest deductions," he said.

Vacation-home buyers using PIP will qualify for financing up to $250,000, a fixed-rate mortgage at 11¾ percent with three percentage points at closing and a five-year "rollover" term. At the end of each five-year term, assuming the borrowers have kept current with their payments, the loan would be renewed for additional five-year periods at the then-applicable rates.

Stripped to its essentials, PIP involves a cut-rate, high-leverage second mortgage (or wraparound loan) on a first home to finance a second home. The lender would have security via a second lien on your first home, as well as the possibility of holding your vacation retreat as partial collateral.

As an example, let's say the current [illegible] on your home produces mortgage interest deductions of $6,000 a year (a $60,000 loan at 10 percent). In the resale marketplace, however, your home is worth twice your loan amount, or roughly $120,000. The PIP plan might provide you additional, secondary financing of, say, $54,000 at 11¾ percent (producing early-year interest deductions of approximately the same level as your first mortgage, slightly above $6,000 a year).

That $54,000 in equity could be applied to an all-cash purchase of, say, a $70,000 vacation or second-home property. Rather than being denied or limited on your interest deductions for the second unit—as under pending tax reform proposals—PIP would allow you to take full deductions because all the mortgage debt legally would be on your first home, not your second.

Berliner's S&L, Second National Building & Loan Association of Annapolis, has prepared still another plan for vacation-property buyers after tax reform. Dubbed IMP, the "Investor Matching Program," the plan will seek to transform leisure-use second homes into 100 percent rental-investment properties, eligible for full mortgage interest deductions and depreciation write-offs. IMP will use a computer to identify comparable-value resort units close to one another. Owners of "matched" units financed through IMP will offer them for rental throughout the resort season and will rent from each other when they wish to make personal use of property.

Because the matched units and owner-to-owner rental payments will be essentially the same, it will be just like the situation before tax reform, Berliner said. According to his tax counsel, IMP participants should qualify for full mortgage-interest deductibility, just like any business-property owners.

Second-home tax reform? If Berliner is typical of the creative real estate minds already at work, the next generation of loopholes could be plainly in sight before Congress finishes with the current generation.

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Time to Dump Weekend Place? Don't Panic Yet

YOUR MONEY MATTERS

By JOANNE LIPMAN
Staff Reporter of THE WALL STREET JOURNAL

Have those dreams about owning a vacation home been shattered by the president's tax proposals? Thinking of dumping that second home before it's too late?

Don't give up yet. Tax proposals do take a swipe at vacation homes, but accountants and financial planners are already devising ways to skirt the problems.

The proposals hit second-home owners because they limit personal interest deductions to $5,000 above net investment income. Deductions for primary homes are excluded. So, under the proposals, most homeowners can deduct only part of their mortgage interest on second homes.

But creative solutions to the interest-deduction problem abound. "You're going to find a lot of novel financing taking place on primary residences," says Stanley R. Perla, a partner in the accounting firm of Ernst & Whinney.

Keep in mind, though, that some of these novel solutions are based on gaping loopholes that legislation could close. Little wonder, then, that the first suggestion of many tax experts is: Avoid dodging proposed laws until some are passed.

But if they are passed, the laws often can be legally avoided. One tactic would be to take out a second mortgage on a primary residence, effectively transferring the vacation-home mortgage to the primary home. That makes particular sense for homeowners with low interest rates on their first mortgage.

For example, a homeowner may have a $150,000 home with a $40,000 mortgage at 6%. He buys a cottage in Maine for $100,000, which carries a $80,000 mortgage. If the tax proposals pass, he might take out a $80,000 second mortgage on his primary house and use the proceeds to pay off the $80,000 on his cottage. His debt level remains the same, but he now can deduct mortgage interest on the full amount.

If a homeowner's mortgage rate on his primary home is high, a better option might be to refinance the home with a much larger mortgage and then pay for the second home in cash.

One pitfall is that if the tax proposals pass, home prices are expected to tumble. So homeowners may not be able to raise as much money from their primary homes as they had planned.

Refinancing isn't the only way to save a vacation hideaway. Owners also could sell the house to a family member and rent it back. "As long as the leasing is at fair market value, there will probably be an opportunity here," says Douglas W. Banks, real-estate service director with Touche Ross & Co., the accounting firm.

This works best when the seller is in a lower tax bracket than the buyer. For example, say a retired couple owns a vacation home on Cape Cod. The couple's children, who are in a higher bracket, can buy the parents' vacation home and rent it back to them at the going rate. The parents will get cash from the sale, which will be taxed at a low rate. The children will get rental income and all the tax benefits of a business—including deductions for mortgage interest and taxes.

A possible problem, however, is that market rent may be much higher than the parents' mortgage and tax payments.

If family members aren't cooperative, an owner might rent out his vacation home. The owner could then deduct part of the mortgage interest and real-estate taxes as business expenses. The big drawback: The owner can use the house only for the greater of 14 days or 10% of the time the house is rented. Otherwise, the house loses its investment status.

There are other, riskier, tax dodges. For instance, "I buy your condominium and you buy mine—and my lease payment equals your mortgage and taxes," says Michael M. Williams, senior vice president of Coldwell Banker, the real-estate unit of Sears, Roebuck & Co. This arrangement may sound good, he says, because it allows each owner to stay in his vacation home and yet get the tax deductions. But, he warns, the Internal Revenue Service will probably disallow deductions claimed by neighbors who buy each others' homes strictly for tax purposes.

Meanwhile, the IRS also will probably be on the lookout for the second-home owner who reshuffles his locale to take advantage of the proposed scrapping of deductions for state and local taxes. People living in states with high taxes may buy a second home in a lower-tax state—and declare it a primary residence.

J. Paul Amaden, a real-estate broker in East Hampton, N.Y., fears that may become common in New York because of the state's hefty taxes. New Yorkers, he says, may "start looking to go to Connecticut or the New Jersey shore."

The CHAIRMAN. Thank you. Ms. Oldham.

STATEMENT OF SALLY G. OLDHAM, CHAIR, COMMITTEE FOR FUTURE INVESTMENT IN AMERICA'S PAST, WASHINGTON, DC

Ms. OLDHAM. I am Sally Oldham, chairman of the Committee for Future Investment in America's Past. This committee is composed of representatives of the public and private sectors who are active in the rehabilitation of this Nation's historic structures and of older buildings generally. The committee includes the National Trust for Historic Preservation, Preservation Action, the American Institute of Architects, representatives of State and local government developers, investment bankers, attorneys, and accountants. We appreciate the opportunity to share with you our experience with the renaissance which is sweeping this country. From Portland, ME to Portland, OR, in small towns and distressed urban areas alike, buildings are being rehabilitated, neighborhoods are springing back to life, entire cities and economies are being revitalized. This is not a random process, Mr. Chairman. This dramatic recovery is occurring for one very important reason, and that is that Congress has made the investment in once-deteriorating buildings and neighborhoods economically viable again with the rehabilitation tax credits. The rehabilitation tax incentives were first included in the Tax Reform Act of 1976. These provisions, which included a 5-year amortization provision and an accelerated depreciation provision, eliminated some of the prior tax laws biased toward investment and new construction. However, they did not adequately compensate investors for the added risks which are inherent in rehabilitating properties which are often located in marginal neighborhoods or in dying central business districts. It was only with the enactment of the three-tier investment tax credit in 1981 that elected officials, preservationists, architects, developers, and community residents could seriously entice investors to put their investment dollars into old buildings in their communities. I viewed this transformation initially from a governmental perspective, as from 1975 to 1982, I was at the National Register of Historic Places in the National Park Service, serving as Acting Chief of Registration and Supervisor of the Register's Tax Incentives Program. In mid-1982, however, I left this post and went into business as an investment banker, structuring limited partnerships to bring investment dollars into developments dealing with rehabilitation and also as a consultant to assist developers with the approval process for the 25-percent investment tax credit. I remember being at the Register in 1977 and 1978, and we had thought with the passage of the 1976 provisions that there would be a tremendous increase in rehabilitation activity dealing with historic properties around the country, but this was not the case. In fact, it was not until 1981 with the three-tier tax credit that we really saw a significant increase in projects. Since the enactment of the 1981 tax law, investment in historic buildings alone has increased fivefold. More than $5 billion has been invested in more than 6,800 historic buildings throughout the Nation. This $5 billion is in large projects as well as small ones. The large ones often serve as anchors for urban revitalization. These include the Old Post Office Building project here in Washington and the Willard Hotel, as well as St. Louis' Union Station project, Pittsburgh's Penn Station project, and Portland's Elk's Temple and Newmarket Theater block. Small projects include ones such as the Hotel Lafayette in Marietta, OH, a community of 15,000 located in the Appalachian sector near the Ohio River or the 16 projects located in East Greenwich, RI, which each involve under $100,000 apiece. Or a project in Jim Thorpe, PA, a community of 5,000, in which the first new business to open in years is in a building alive again because of the tax credit. As neighborhoods in central business districts experience this renaissance, State and local economies of which they are a part receive the benefits of increase employment and wages, and thus increased collection of income, sales, and property taxes. The national trust estimates that, since 1982, in historic projects alone, more than 180,000 new jobs have been created, $5.3 billion in increased local retail sales, and general business activity has been generated, and more than $4 billion in increased wages. This credit, Mr. Chairman, is restoring properties and people to State and local tax rolls more effectively and efficiently than many of the direct subsidy programs of the past. The credit is responsible for the creation of more than 36,000 housing units in historic properties, and these are often in the conversions of underutilized, often abandoned commercial, industrial, and educational buildings.

This program, Mr. Chairman, which I would like you to understand we believe very firmly works. It involves a broad partnership of the public and private sectors. It is a targeted program, and it is one that is just getting started. It is yielding revived neighborhoods and businesses, creating jobs, increasing tax revenues, providing affordable housing, preserving old and historic buildings for future generations, and providing for us now and in the future a sense of continuity with our cultural past. In the words of your colleague last week at the Ways and Means Committee, Mr. Schulz, "this program does not cost; it pays." Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared written statement of Ms. Oldham follows:]

STATEMENT OF SALLY G. OLDHAM
CHAIRMAN
COMMITTEE FOR FUTURE INVESTMENT IN AMERICA'S PAST
BEFORE THE COMMITTEE ON FINANCE
JULY 16, 1985

Good morning, Mr. Chairman and Members of this distinguished Committee. I am Sally Oldham, Chairman of the Committee for Future Investment in America's Past (CFIAP). CFIAP is composed of representatives of the public and private sectors who are active in the rehabilitation of our nation's historic structures and older buildings generally. CFIAP includes the National Trust for Historic Preservation, Preservation Action, the American Institute of Architects, state and local government representatives, developers, investment bankers, architects, attorneys, and accountants active in rehabilitation. CFIAP appreciates this opportunity to appear before you today to share with you its experience with a renaissance which is sweeping the country. From Portland, Maine to Portland, Oregon, in small towns and distressed urban areas alike, buildings are being rehabilitated, neighborhoods are springing back to life, entire cities and economies are being revitalized. This is not a random process, Mr. Chairman. This dramatic recovery is occurring for one very important reason -- Congress has made investment in once deteriorating buildings and neighborhoods economically viable again with the rehabilitation tax credits.

While the passage of the historic preservation tax incentives in the Tax Reform Act of 1976 eliminated some of the prior law's bias towards investment in new construction, five-year amortization and accelerated depreciation did not totally compensate investors for the many additional risks inherent in the rehabilitation of historic structures and older buildings generally which are often in marginal neighborhoods or dying central business districts. It was only with the enactment of the three-tier system of investment tax credits that elected officials, preservationists, architects, developers, and community residents could seriously entice investors into putting their investment dollars into an old building in their community. This was a transformation which I observed initially from a governmental perspective as I worked from 1975 to 1982 at the National Register of Historic Places in the National Park Service (NPS), serving as Acting Chief of Registration and Supervisor of the Register's tax incentives program. The NPS is the federal office which issues approvals for the 25 percent investment tax credit. At mid-year in 1982, however, I left this post and went into business as an investment banker, structuring limited partnerships to attract investment dollars to development projects involving rehabilitation, and as a consultant, to assist developers with the NPS approval process for historic tax credit projects.

The up-front return to investors in the form of a credit, available for qualified rehabilitation since January

1, 1982, makes the investment attractive from the investor's perspective, while for developers, once financially impossible projects become feasible because the influx of equity may permit a reduction in the amount of funds debt-serviced, or provides funds to cover deficits during the lease-up period of a project. As evidence of the credit's attractiveness, since January 1, 1982 when the 25 percent credit first became available, investment in historic buildings alone has increased five-fold, with more than $5 billion being invested in more than 6,800 historic buildings throughout the nation.

This $5 billion is investment in large projects which serve as anchors for urban revitalization from which smaller projects will flow like Washington, D.C.'s Old Post Office Building and the Willard Hotel, St. Louis' Union Station retail, commercial and hotel complex and Portland's Elks Hall. But it is also investment in much smaller projects such as in the Hotel Lafayette in Marietta, Ohio, a community of 15,000 located in the Appalachian sector near the Ohio River; $11.3 million of it is in 19 tax credit projects in Athens, Georgia. And it is on Main Street in towns as small as 5,000 such as Jim Thorpe, Pennsylvania where the first new building to open for years is located in an old building alive again because of the historic rehabilitation credit. In fact, the rehabilitation costs of 62 percent of historic residential projects are less than $150,000, according to National Trust estimates, while the rehabilitation costs of 80 percent of the historic commercial projects are less than $1 million .

What is increasingly apparent is the ripple effect that a single rehabilitated building can have in a central business district or neighborhood. New residential units create the need for the nearby services of corner grocery stores, dry cleaners, restaurants. Moreover, adjoining landowners often begin property improvement when a neighboring building is rehabilitated, whether or not the credit is available to them.

As neighborhoods and central business districts experience this renaissance, the state and local economies of which they are a part receive the benefits of increased local retail sales and business activity, increased employment and wages, and thus, increased collection of income, sales, and property taxes. The National Trust, which has developed the most sophisticated national data base of tax credit projects, estimates that since 1982, historic rehabilitation projects alone have led to more than 180,000 new jobs, and have generated $5.3 billion in increased local retail sales and general business activity, and $4 billion in increased wages. The credit, Mr. Chairman, is restoring properties and people to our state and local tax rolls more effectively and efficiently than many of the direct subsidy programs attempted in the past. As Mayor Richard K. Berkley of Kansas City, Missouri, has emphatically stated:

> "Over a period of years, many federally-designed and funded programs have been devised to find answers to the urban problems that have plagued our cities. The tax credits for rehabilitation, in my estimation, is the first program that has really worked. The low-interest loan programs, urban renewal, E.D.A., and other efforts have not provided the needed solutions. There is no substitute for the rehabilitation tax credits. This is the successful marriage of public funds with private money, and private money which is invested at risk."

The credit is now being recognized for the much-needed housing it has created, particularly in urban areas where low and moderate income rental housing is a scarcity. More than half of all historic rehabilitation projects are housing. Since January of 1982, more than 36,000 housing units have been rehabilitated, more than half of these created by converting underutilized and often abandoned commercial, industrial and educational buildings. Philadelphia estimates that in its Old City, use of the historic tax credit has resulted in 2,000 units, a 300 percent increase in housing units. In fact, 90 percent of housing starts in Philadelphia last year resulted from construction activity induced by the rehabilitation tax credit. Philadelphia's experience is not unique. In many other cities and towns, the rehabilitation of vacant, formerly industrial buildings into residential units has reversed a neighborhood's deterioration by bringing people back into the neighborhood; these new residents create the need for supporting commercial activity and services, stimulating the rehabilitation of the surrounding buildings.

This is tangible evidence, Mr. Chairman, that the rehabilitation credit is doing exactly what you intended it to do in 1981. By giving the businessman the incentive to invest in an older building in an older neighborhood, you have reversed what had seemed to be an inexorable trend to "move out and tear down." The credit is enabling the private sector to succeed at revitalizing our dying cities, towns, and neighborhoods, a feat at which government at all levels has failed so miserably before. It is working where other governmental programs have failed because the decisions are made by the businessman and investor whose money is on the line. They must find a building which, when rehabilitated, has a viable economic use. The operation and maintenance of the building will be financed by the economic activity it generates within its walls and in the surrounding areas. The credit makes the building's rehabilitation viable by reducing the additional risks involved with the rehabilitation of older buildings. It allows rehabilitated buildings to compete on a level playing field with new construction and other assets for investment dollars.

Yet, in spite of this demonstrable, tangible success, the President proposes to take away this catalyst for revitalization in mid-stream. When combined with the other changes being proposed to restrict depreciation, limit investment interest deductions, and extend the at-risk rules, the financial risks of investing in older buildings will be so great that no good businessman will dare to do so. In the absence of the credit, it will make more economic sense to tear down and build anew, or simply tear down. Rehabilitation will always be more costly, with the odds of becoming a commercial success greater than with new construction. You will, in effect, be abandoning the older areas of this nation's communities.

In fact, that is already happening. The suggested repeal, particularly in its failure to provide transition relief, has halted investment in rehabilitation projects all over the country. There are numerous projects on which commitments have been made but construction has yet to begin, and others in which construction has begun but is not completed, and will not be by January 1, 1986. The uncertainty has had the same effect as if you had already repealed the rehabilitation credit.

You and your colleagues on the Committee face difficult choices in attempting to reform our admittedly complex and often unfair tax laws. But in doing so, the CFIAP urges you to move carefully -- weigh the benefits accruing to our communities from the rehabilitation credit and related provisions of current law against whatever simplicity and revenue might be gained by their repeal. We believe you will find that the benefits of the credit -- the revived neighborhoods and businesses, the jobs created, the increased tax revenues collected, the affordable housing made available, the old and historic buildings preserved for future generations' use and which provide a sense of continuity with our cultural past -- far outweigh its repeal.

Thank you for your attention.

The **Chairman**. Senator Mitchell, I believe you would like to introduce the next witness?

Senator **Mitchell**. I would, Mr. Chairman. I am pleased to welcome Michael Liberty, the president of the Liberty Group of Portland, ME. Michael is a young man who has done an outstanding job in the area of low-income housing in the rural parts of Maine, and I look forward to his testimony, as I know the other members of the committee do.

The **Chairman**. Good to have you with us, Mr. Liberty.

STATEMENT OF MICHAEL A. LIBERTY, PRESIDENT, LIBERTY GROUP, INC., PORTLAND, ME

Mr. **Liberty**. Thank you, Senator Mitchell. Mr. Chairman and members of this distinguished committee, my name is Michael Liberty. I am president of Liberty Group, Inc. of Portland, ME. I also serve as State chairman for Maine on the Council for Rural Housing and Development, a national organization for the multifamily development industry. I am here today to express my concern about the proposed tax law changes as they affect my business as a developer of rural and low income housing, as well as the economy of the State of Maine. Over the past 5 years, my company has developed over 1,000 housing units in rural Maine, affordable housing that wouldn't have existed without tax incentives that have allowed us to raise capital from investors who include largely small business people and professionals. You have heard, and will hear many times before these hearings end, technical discussions of the economics of the proposed tax reform. I would like to give you my personal account of what I do and how it creates jobs, tax dollars, and housing for citizens in Maine. You have seen heavy statistics, charts, and figures from other witnesses. I want to tell you my story in human terms. I was 20 years old with a dream of becoming a housing developer. The problem was I had less than $3,000 to my name, and I realized that I had to find investors to be able to get into the housing business. Thus, I became familiar with limited partnerships. Shortly thereafter, I located a rundown 20-unit apartment project in Rockland, ME, occupied by senior citizens. The Farmers Home Administration, which was assisting the project under its section 515 program, had no choice but to proceed with a foreclosure, as the owner was in bankruptcy. Its residents would have had to find other housing, which wasn't available in that community. But we were able to raise $180,000 through the sale of limited partnership interests to Maine investors and purchased and rehabilitated the project. Today, those elderly people continue to live there affordably and more comfortably. In addition to the 20-unit project, my company went on to do another rehab of a 34-unit elderly housing project in Winterport, ME, again using investment capital as the key ingredient. In total to date, we have done over 1,000 housing units in rural Maine, each creating jobs and tax dollars, each supplying housing to people who will always be happier for having a decent place to live. And what has made all this possible? The sale of limited partnership interest to private investors, something we would be hard pressed to accomplish under the tax proposal Congress is considering. Tax incentives make the sale of

limited partnerships possible. They are the backbone of my company and the real estate industry. Without them, my industry could not have invested $29 million in Maine last year to develop 33 low-income housing projects, moneys that generated close to $90 million in total spending throughout our State's economy and created some 3,500 jobs. In other words, this particular real estate investment generated three times its value in the State's economy. Gentlemen, I am a newcomer to the American free enterprise system for the simple reason that, in 1978, I had just graduated from high school, but I was fascinated by a system that rewards an entrepreneur based on the amount of effort and energy and creativity he puts into a career. More than that, I was and am impressed by economic productivity. I never imagined that as a high school senior 7 years ago, I would be supplying jobs to the State of Maine, that I would be supplying housing to the needy, senior citizens, and people who otherwise wouldn't have a place to live. I am surprised and I am proud. The tax reform proposal would greatly restrict our ability, if not completely prevent us from raising capital through the sale of limited partnerships. This would upset the delicate balance between risk and reward that make our economy work. Incentives for capital investment particularly for the construction and ownership of rental housing should be maintained. Moreover, special consideration must be given to low income housing needs.

Decent and affordable housing has been an American dream for the past two centuries. For the past 50 years, the Federal Government has been active in promoting this ideal through housing programs and the Tax Code. I urge the committee to study each proposed change in detail and carefully consider the overall result of the administration's proposal. It may be less simplicity, less fairness than we have now, and the economic results could be disastrous. We presently have incentives directed toward capital formation for real estate, specifically depreciation allowances and the use of limited partnerships as a means of capital formation. These incentives should be kept. There is now a rental housing shortage. Unless we are careful, the shortage will be overwhelming. Many families will be left on the outside looking in. I am sure this is not what we want. Productive incentives that encourage decent and affordable housing must not be damaged. Otherwise, all Americans will suffer. I want to continue to do my job and provide housing for senior citizens, young families, for all Americans, but you must let me have the tools to raise the money to do the job. What are my tools? Investment incentives; and I am not talking about incentives for banks, insurance companies, and the rich. I am talking about the heart of America, who wants to invest in local housing projects. They would like to see their dollars working to help their community, but we must give them an economic reason to invest; for without the flow of limited partnership capital from the modest savings of these people, I cannot continue to supply the housing which is so vital to our superb way of life. Please do not take away our tools. Thank you for listening to my personal story.

The CHAIRMAN. Thank you, Mr. Liberty. That is quite a success story for a young man.

[The prepared written statement of Mr. Liberty follows:]

LIBERTY GROUP
REAL ESTATE DEVELOPMENT

TESTIMONY OF MICHAEL A. LIBERTY
PRESIDENT OF LIBERTY GROUP, INC.
PORTLAND, MAINE
BEFORE SENATE FINANCE COMMITTEE
JULY 16, 1985

Mr. Chairman and members of this distinguished committee, my name is Michael Liberty, I am president of Liberty Group Inc. of Portland, Maine. I also serve as state chairman for Maine on the Council For Rural Housing and Development, a national organization for the multi-family development industry.

I am here today to express my concern about the proposed tax law changes as they affect my business as a developer of rural and low income housing, as well as the economy of the state of Maine. Over the past five years, my company has developed over a thousand housing units in rural Maine, affordable housing that wouldn't have existed without tax incentives that have allowed us to raise capital from investors who include largely small business people and professionals.

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You have heard and will hear many times over before these hearings and technical discussions of the economics of the proposed tax reform. I would like to give you my personal account of what I do and how it creates jobs, tax dollars, and housing for Maine citizens. You've seen heavy statistics, charts, and figures from other witnesses. I want to tell you the story in human terms.

I was 20 years old, with a dream of becoming a housing developer. The problem was I had less than $3,000 to my name, and realized that I had to find investors to be able to get into the housing business and thus became familiar with limited partnerships. I then found a rundown 20-unit apartment project in Rockland, Maine, occupied by senior citizens. The Farmers Home Administration, which was assisting the project under its section 515 Program, had no choice but to proceed with foreclosure as the owner was in bankruptcy. Its residents would have had to find other housing, but we were able to raise $180,000 through the sale of limited partnership interests, and we bought and rehabilitated the project.

Today, those elderly people continue to live there affordably and more comfortably.

In addition to the first 20 unit project, my company went on to do another rehab of a 34-unit elderly housing project in Winterport, Maine; again, using investment capital as a key ingredient. In total, to date, we have done over 1,000 housing units, each creating jobs and tax dollars. Each supplied housing to people who will always be happier for having a decent place to live.

And what has made this possible? The sale of limited partnership interests to private investors--something we'd be hard pressed to accomplish under the tax proposal Congress is considering.

Tax incentives make the sale of limited partnerships possible. They're the backbone of my company and the real estate industry.

Without them, my industry could not have invested $29 million in Maine last year to develop 33 low income housing projects, monies that generated close to $90 million in total spending throughout our state's economy and created some 3,500 jobs. In other words, this real estate investment generated three times its value in the state's economy.

Gentlemen, I'm a newcomer to the American free enterprise system for the simple reason that in 1978, I had just graduated from high school. But I was fascinated by a system that rewards an entrepreneur based on the amount of effort and energy and creativity he puts into a project.

More than that, I was and am impressed by economic productivity. I never imagined that as a high school senior six years ago I would be supplying jobs to the State of Maine, that I would be supplying housing to needy, senior citizens and people who otherwise wouldn't have a place to live. I'm surprised and I'm proud. The Tax Reform Proposal would greatly restrict our ability if not completely prevent us from raising capital through the sale of limited partnerships. This would upset the delicate balance between risk and reward that makes our economy work.

Incentives for capital investment, particularly for the construction and ownership of rental housing should be maintained. Moreover, special consideration must be given to low-income housing needs.

Decent and affordable housing has been an American dream for the past two centuries. For the past 50 years, the Federal government has been active in promoting this ideal through housing programs and the tax code.

Of course we all support tax fairness and simplification. However, I urge the Committee to study each proposed change in detail and carefully consider the overall result of the Administration's proposal. It may be less simplicity and less fairness than we have now. And the economic results could be disastrous.

I hear a lot about special interests in Washington. Well, I can tell you right now: housing is not a special interest--housing is a national interest. We presently have incentives directed toward capital formation for real estate, specifically depreciation allowances and the use of limited partnerships as a means of capital formation. These incentives should be kept and strengthened.

There is already a housing shortage. Unless we are careful there will be no new housing. Many families will be left on the outside looking in. The dreams will end.

Is this what we want? No. I know it is not what the state of Maine wants. Productive incentives that encourage decent and affordable housing must not be damaged. Otherwise, all Americans will suffer.

I want to keep doing my job--supplying housing for senior citizens, for young families, for all Americans. But you must let me have the tools to raise the money to do the job.

What are my tools?

Investment incentives. And I'm not talking about incentives for banks, insurance companies, and the rich. I'm talking about the heart of America--the small investor who wants--indeed likes--to invest in local housing projects. But we must give them a reason to invest. For without the flow of limited partnership capital from the modest savings of these people, I cannot continue to supply the housing which is so vital to our superb way of life.

Don't take away our tools!

Thanks for listening to my personal story.

The **Chairman**. Mr, Zigas, you favor retaining the historic tax credit?

Mr. **Zigas**. Yes, sir, I do. And in the context of the fact that we are now working with a number of nonprofit organizations who are, for a change, using some of these historic tax credit provisions, both to do community development which benefits their community and to spin off investment income they can use in low income housing. We have a group in Philadelphia that has had their low income community done through the historic certification process, and they are using the proceeds from these kinds of syndications as a nonprofit developer of low income housing.

The **Chairman**. What is your view on keeping the credit for the older but nonhistoric buildings?

Mr. **Zigas**. It is not my field, Senator, and I would feel I am really getting out of my depth by commenting on the efficacy of it or not. From the low income housing perspective, I know that clients of mine—people we represent—are using a wide range of these incentives; and in the absence of direct subsidies, they are all they have left, and they are drawing in private investment to help them achieve their goals.

The **Chairman**. Let me ask each of you this, and I will start with Mr. Shepard. You heard the testimony of the panel before you that was basically commercial real estate. Each one of you have a slightly different interest, although some of you are more disproportionately interested in low income or rural housing than others. How do you suggest this committee rank the priorities? We are going to be faced with a $250 billion deficit, I think. We are trying to make a tax bill come out neutral, and we cannot accommodate everybody. We cannot accommodate second homes, no matter what their cost, and commercial real estate and low income housing and historic tax credits and rehabilitation tax credits, on and on. What do you suggest we do?

Mr. **Shepard**. I would like to just begin by making a statement, Mr. Chairman, that I question whether the proposals affecting real estate in general will actually, after a period of years, net increased income to the Government because of their very negative economic impact. And I think at some point an economic indepth analysis should be done of these proposals. The loss of jobs in the construction industry and the lack——

The **Chairman**. The President presumes that the money doesn't go into a sock, that it goes to some other economic activity which is a higher and better use, once you get rid of the subsidies; and that will indeed produce more jobs and more efficiencies than if we keep the various subsidies, which are not limited to housing. I mean, they are not limited to real estate. They are replete through the code.

Mr. **Shepard**. If indeed that happens in their efficient a manner, of course it will be a tremendous displacement in the construction and real estate industries. But to specifically answer your question, Mr. Chairman, the most onerous, I guess—I will start from the top—are the at-risk provisions and the arbitrary definition of a limited partnership interest as investment interest, as opposed to business interest, even though indeed it is a business. These two provisions, in effect—any one of these two, if one is passed and the other one isn't—it is still has the same effect. It in effect negates the use of the limited partnership vehicle as an investment vehicle in the housing industry. Of course, that has many ramifications. It is the limited partnership that has made available real estate to small investors and medium-size investors and basically has been the backbone of the housing industry. Institutions continue to support commercial real estate. Basically, they haven't been interested in housing since 1973. And our investment has been driven strictly by these limited partnerships—I can't say strictly—but the overwhelming majority. Secondly, the low income advantage vis-a-vis other real estate comes from the depreciation advantage, having a shorter year life which we currently enjoy than other real estate, and secondly, being able under section 189 to deduct construction period interest. These are about the only advantages we have against other real estate; and of course, other real estate offers appreciation and potential cash flow. I guess the last comment I would make is that we would be hurt severely by the transition rules as offered by the Administration.

The **Chairman**. You know, I think, considering the time, I am not going to ask the rest of the panel to answer the question because I can see the way the answers will come, whether it is second homes or historic buildings with Ms. Oldham, or Mike Liberty and his low-income housing. We are just going to have to decide the priorities of the country as best we can. There is a debate that goes on as to whether it should be straight-out appropriation versus tax credits, and that is another issue. But my hunch is that this committee is still going to lend itself toward using the Tax Code for incentives. And we will simply have to stack up the priorities and the deficit and pray that we get a bill that at the minimum is revenue neutral. I don't even know if we are going to do that. Senator Danforth?

Senator **Danforth**. Thank you, Mr. Chairman. If you are going to rely on prayer, you have to come to the right place. [Laughter.]

The **Chairman**. I am curious. You have been in this Congress now for 8 years. Have you been praying all that time for the deficit? [Laughter.]

Senator **Danforth**. I have been praying for you. I want to follow up on a comment that Senator Packwood made because I think that the rehabilitation tax credit really puts in perspective what we are about. The basic queston that we are going to be facing over and over again is: How do we feel about the various incentives that are in the Tax Code to do all kinds of good things? If we are going to come up with enough revenue to yield tax rate reductions, the only way to do it is to do away with some of the preferences that are in the code. Now, the rehabilitation tax credit is something I think I have probably heard about more than any other single thing that is being proposed. This is probably true for every city, but in Kansas City and in St. Louis, the rehabilitation tax credit has been so widely used. I think that is true. I mean, Mr. Shepard knows whether this is, in fact, true, or perhaps Mrs. Oldham; but I think that it is true that St. Louis has been the largest single user of the rehabilitation tax credit.

Mr. **Shepard**. That is true, Senator. There were 230 projects, I think.

Senator **Danforth**. How much?

Mr. **Shepard**. I think 230 projects in St. Louis.

Senator **Danforth**. I thought it was like 700 and some odd. I don't know, but I was put in a van last winter and taken on a tour; and I think they showed me about 80 percent of them. [Laughter.]

There is one over there—and I would be looking at my watch, you know—when do I get out of this van? It has been a major benefit to St. Louis, and it has been a major benefit to Kansas City. And it does, I think, put in a specific case the proposition that Senator Packwood has been raising. The rehabilitation tax credit has been used in our State for projects both large and small. The rehabilitation of residences all the way to the UDAG project that is at Union Station. Isn't that right?

Ms. **Oldham**. Yes.

Senator **Danforth**. And it has been one of the keys to that Union Station project. Now, from the standpoint of utilizing existing resources in this country, it would make sense to me to try to figure out ways to keep buildings, like the Union Station in St. Louis—not to mention a very considerable housing stock, which is in pretty good shape—in utilizing it, rather than tearing everything down. So, it would seem to me that this would be an area where we would have to give it very careful study. Also, the revenue gain from abolishing it—and I might add that this isn't just the administration's proposal. Everybody's proposals, including Senator Bradley's proposal, would abolish the rehabilitation credit, so it is not just what is in Treasury II. Everybody says we should get rid of it, except those who feel that it serves a useful purpose. But the revenue to be picked up in 1986 is $100 million, and then it goes up. In 1987, it is $400 million; in 1988, it is $1.2 billion; and then in 1989, $2.1 billion; and in 1990, about $2.7 billion. But I don't think that these figures take into account, and maybe they do, but I don't think they take into account any economic reflows from the credit. Do you know that, whether that is so?

Ms. **Oldham**. I don't believe that they do.

Senator **Danforth**. Doesn't it make sense that if you have people at work in St. Louis and Kansas City rehabilitating buildings and providing places for people to live and for communities to grow, doesn't it make sense that the loss in revenue from the rehabilitation tax credit yields certain offsetting revenues to the Treasury? I mean, that would make sense, wouldn't it?

Mr. **Shepard**. It would.

Senator **Danforth**. Would you agree that, if we do abolish it, at the very least the transition rule should be such that we would make it absolutely clear that projects which were commenced prior to any legislative action being taken on the President's proposal would be eligible for the credit?

Mr. **Shepard**. Absolutely. Senator, I might mention that, even though I am a rural developer, I do have an historic rehab development going in the city of St. Louis, on which we have already started construction and it is a tremendous race. The weather has to be right, and everything has to be right. With the Treasury proposal, if we don't finish that by the end of December, the whole thing is lost and it will be a financial disaster. So, it is a very high-risk thing. This just doesn't seem fair and equitable.

Ms. **Oldham**. May I make a comment on that also? I think that whatever kinds of assurances can be received from the committee would be tremendously helpful in tems of developers who are undertaking these projects now, that have perhaps been in the planning stages for 1 or 2 years and need to have some assurance that they can continue and be able to receive the credits. Thank you.

Senator **Danforth**. Thank you, Mr. Chairman.

The **Chairman**. Senator Long.

Senator **Long**. I have been very much impressed by the testimony of this panel. Mr. Zigas, just one thought occurs to me. I have been thinking about it for a year and longer. It just amazes me to see in the wintertime pitiful wretches out there in the cold sleeping all night in the snow and and that type of thing, here in Washington, DC. If only for the image of this great country, it seems to me we ought to move these people somewhere off those street corners and off of Lafayette Park, but our burden is to see to it that when we move them that we have a place to put them. We ought to have a shelter to put them in and it ought to be a warm shelter. I take it that you aren't saying that the tax incentives are the best ones for the problem, but at the moment this is all we have left, and the last thing is to get rid of that. That is basically your position?

Mr. **Zigas**. Yes, sir, Senator. I think it is. I mean, we are, in the low-income area, kind of like a table with three legs gone, and this proposal is just about getting ready to kick the last leg out from under us. These tax provisions are not going to help. I will say right now that they will not provide any kind of substantial housing for the legions of homeless people on the streets of America's cities today; but by eliminating these provisions and preferences, you certainly aren't going to help the homeless either. And Congress has already made a decision on the spending side to withdraw almost all of its support from direct spending. I would make another point which is that in some of the projects in which investments have been made in the past and for which new equity must be raised if they are to be maintained for low-income occupancy over the near and long term, some of these tax preferences appear to be very critical, unless again the Federal Government is ready through appropriations and authorizations to greatly expand the direct flow of subsidy to enable these low income tenants to pay rents that are affordable and still provide a reasonable rate of return to recoup the investment these properties need and to attract investment into them. So, I think you are talking about a fairly big picture here. But yes, our position is that there are probably lots better ways to help low income people with their housing than to do it through the Tax Code. Most of those have been taken away from us over the last 5 years and no replacement made. In this climate, it would just be irresponsible, it seems to us, to adopt these proposals willy-nilly with no attempt to reform them, change them, somehow make them work better to achieve some of the objectives that I think we all agreee ought to be part of our housing policy.

Senator **Long**. You would rather have what we have than nothing, in other words?

Mr. **Zigas**. I have been saying that for 5 years. I am down to the bottom here. That is right.

Senator **Long**. Now, Mr. Cymrot, you gave the illustration and do you think that is a rather typical illustration of what is likely to happen to a family with $25,000 having a rent increase that would exceed their tax increase by 6 to 1?

Mr. **Cymrot**. Yes, sir, I do. The ultimate driving force behind everything is supply and demand; and the construction industry, by its very nature, has no initial cash-flow to offer. By its very nature, it is a longer form of investment since it is something that you have to start from the beginning, as compared to existing units. The only thing new construction has to offer are tax benefits, and once you start to restrict those tax benefits, you will not have new construction. In the last several years, construction and existing property have been in parity. I don't think most people realize that, and the major reason that investment capital has been attracted to the construction industry is that developers had to give extensive guarantees as to debt service being maintained for several years or certain competitive cash-flows. With the passage of some of this legislation, if not all, I don't believe the developer will be in a financial position; or as my predecessors had indicated on the other panel, certainly the smaller developers will not be in the position to take advantage or give the types of guarantees necessary. And supply and demand will simply take over.

Senator **Long**. Let me just congratulate all of you. The six of you have testified on this panel with a very impressive presentation. I am fully convinced that we ought to do something along the lines that you are advocating here. From my point of view, it doesn't bother me at all to think in terms of putting a tax on to pay for some of this big tax cut that we couldn't afford. There was $150 billion a year tax cut, based on the assumption that it was going to generate more than $150 billion of additional revenue. We were supposed to make a profit out of all that, and it didn't work. Well, when you do something that doesn't work, you ought to change it for something better. I have already made my position clear to the President. I think that some of this tax cut—it was something we couldn't afford. One way or the other, we ought to be moving to pick some revenue up to avoid adversely affecting some of those from whom this panel of witnesses has spoken about today. The President might veto it, but I would be willing to help make his day by having a try, anyway. [Laughter.]

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman. On Pennsylvania Avenue, as you drive down Pennsylvania Avenue and you get to the White House, and then you drive in front of Pennsylvania Avenue, and you get down a little bit—are any of you familiar with this big glass building? And then, immediately in front of it are, like, seven or eight two-story buildings. Are you familiar with that area? Is that your project?

Mr. **Zigas**. My project?

Ms. **Oldham**. No; you are thinking of Red Lion Row. Is that it? Yes; I think that is what it is called.

Senator **Bradley**. It looks a little bit like Disneyland? Did they use the rehab credits or the historic credits?

Ms. **Oldham**. They would not have used the rehab credits because, in order to qualify, you have to meet two different standards. You both have to spend an amount of money which exceeds your adjusted basis in the property and additionally, you also have to retain 75 percent of the exterior walls of the property. So, if you take a building such as that or, for instance, the Army-Navy Club that is being done here, when you just see the facade that is propped up and a whole new building built behind it, that does not qualify for the rehabilitation credits.

Senator **Bradley**. Why do they keep the facade like that?

Ms. **Oldham**. I suppose because it gives the building additional character.

Senator **Bradley**. So, the building doesn't qualify for rehab if they have simply their——

The **Chairman**. It qualifies for the rehab, doesn't it? It doesn't qualify for historic.

Ms. **Oldham**. It would not qualify for any of the rehab credits. Oh, someone is making a suggestion to me as well that it may be that they are under review by the D.C. Government and there is a requirement because of that that they maintain the facade, even though it wouldn't get a tax credit.

Senator **Bradley**. OK. I must say that I have driven down that street now about 10 times in the last month, and I see this eight-story facade being propped up by a boom; and I wonder why they are doing that.

Mr. **Shepard**. I think it is just a requirement of the District, that they keep the facade for some reason.

Senator **Bradley**. I see. I was interested in your testimony, Mr. Cymrot. And I think a couple of the witnesses testified as to how important it is that we make sure we keep things for low-income people. My question to you is: Why don't we then do renters' credit? You say that the laws of supply and demand are the important thing in the economy. Why don't we just give the poor people the means to pay the rents, as opposed to giving the developers the breaks?

Mr. **Cymrot**. Do you want me to answer that?

Senator **Bradley**. Yes.

Mr. **Cymrot**. I am not sure I understand the purpose of giving, even with the phraseology, the poor people the breaks as against the developers.

Senator **Bradley**. If the purpose here is to provide poor people with housing and you believe that the laws of supply and demand are clearly the most efficient way to allocate resources, then if there are poor people who need housing, you can either give them the means to purchase the housing at what the market price would be, under your analysis, an increase of 20 percent in rents in the next 5 years, or you can give the developer the subsidy.

Mr. **Cymrot**. I don't see where that is going to create housing.

Senator **Bradley**. I thought the demand would create the housing. Doesn't the demand create the housing?

Mr. **Cymrot**. I am still not sure where that is going to create housing, other than some kind of bureaucratic nightmare to give charitable checks out to people so that they can then decide where to live with these checks. That certainly doesn't seem to make sense.

Senator **Bradley**. Mr. Zigas.

Mr. ZIGAS. Senator, I might just comment that the proposal for some kind of refundable tax credit to offset these increases was, in fact, discussed quite seriously with HUD, and they did some econometric modeling of it. And I think the real issue here is that, were the Congress to go in that direction, you might find for much of the existing housing stock, that it would in fact provide enough income stream to provide an incentive, but it is an extremely expensive means by which to do it. It might well be more effective and more efficient. I think HUD's figure showed for families—renters—with incomes under $8,000, it was upwards of a $10 billion a year expenditure. And to go to a universal housing entitlement on the same basis, they say everybody shouldn't be spending more than 30 percent of their income for rent, and we are prepared to provide either a certificate to that effect with direct spending or a refundable tax credit to them to ensure that. And at some point, people will stop wanting to take it because it won't make sense to them economically. That was upwards of a $30 billion a year expenditure. Now, if you could put that much money in the real estate economy—I am not an economist and I am not a developer—but I dare say many of the people I represent would have most of their housing problems disappear overnight. But it is an amount of money this Congress has consistently refused to provide for these kinds of programs, and that is the rub.

Senator BRADLEY. Mr. Chairman, could I just finish up this point? We were in this committee a couple of weeks ago, and we had the Commissioner of the IRS in here. And he said that the number of tax shelter cases under audit or review now, is what, 260,000. And 10 years ago it was 400. It seems to me that, if you are arguing about efficiency, there is the efficiency of providing a direct subsidy and having an oversight role versus the efficiency of providing a subsidy to developers and then letting them take their chances over 10 to 15 years in the audit lottery. And I think that the committee wants to be guided by what is the best for those individuals who we are trying to provide housing to, not necessarily what is the advantage to the group that has managed to zero out with the tax benefit.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Ms. Oldham, I want to say that I think the presentation that you and Mr. Shepard made on the rehabilitation tax credits were very good ones, and I have been deeply interested in that. I think one of the other virtues of it is it keeps the buildings where the infrastructure is—the sewers, the schools, the roads—instead of paving some outskirts of town and taking over one or more farmland area to build new housing, as we are seeing all around the greater Washington metropolitan area. I really question, Mr. Zigas, whether the use of the rehabilitation tax credits have done much for low-income housing, and I wish you would answer briefly. I have toured around and seen a good deal of the use of the historic and the rehabilitation tax credits, but I must confess I haven't seen much of it used for low-income housing. Have you seen examples of that?

Mr. ZIGAS. No, Senator. What I was trying to say is that I think historically we have not seen a tremendous amount of housing financed that way. Much more rehabilitation of housing is the result of the 167(k) provisions, which provide the rapid writeoff. What I was trying to say is that, in the absence of Federal development subsidies and with the withdrawal generally, many low-income organizations, nonprofit development groups, have learned to latch onto some of these incentives and begin to make them work for low-income community development by attracting equity investment into some of these properties.

Senator **Chafee**. All right. Now, let me ask you something else. We sit here, and the first day we had some testimony in favor of the tax reform. Ever since then, panel after panel has come and told us how it is going to bring completely to a halt whatever area they are interested in. With you, it is low-income housing. And the thing that bothers me is that there was low-income housing built in this country before 1913 and the Revenue Code, and there was low-income housing built for years and years and years, if you would just look around the Washington, DC or any of our home areas, that is what all the three-deckers were. They were built in my home State—the three-decker housing—that was low-income housing. It seems to me that what you are saying is that, absent these credits, special deductions, exemptions, and so forth, everything is going to come to a grinding halt. What about the fact that people are going to have more money? The tax rates are going to be lowered. They are going to invest that in some way. I think, Mr. Zigas, in your presentation you said that they can't make any money on low-income housing. Well, if they can't make any money on low-income housing, why was low-income housing built for years and years in this country before anybody dreamed of the Federal Government getting into it?

Mr. **Zigas**. Senator, if I might be permitted, I think it is a mistake to say that thousands and thousands of units of low income housing were ever built for that purpose. We did have a history in the United States of housing filtering down. In the 1950's, we came to call it tenement housing, and we put a lot of Federal money into tearing it down. The supply or affordable housing to low-income people has been shrunken dramatically since 1970. An analysis my organization has done of the numbers of people who——

Senator **Chafee**. But I am asking you historically.

Mr. **Zigas**. Historically, there has been very poor housing affordable to very low-income people, and the Federal Government, in 1934 and 1937, made a very deliberate decision to begin to invest in housing, specifically to help alleviate those problems. And we have had a 50-year history of that. We have now seen, since 1980, a very deliberate withdrawal from the direct subsidy side from that kind of support, which has filtered out——

Senator **Chafee**. Now, let me ask you this question. When the masses of humanity came to the United States in the great days of the immigrations, in the latter part of the last century and the early part of this century, they lived in housing.

Mr. **Zigas**. Like my grandparents, sir, they lived in cold-water, walkup flats, overcrowded conditions, the kind of things Lincoln Steffans called the shame of the cities. And there was a lot of interest in that kind of housing about 50 to 80 years ago, and all I am saying, sir, is that the Government has made a deliberate policy in the last 50 years of saying that is not a condition we ought to tolerate, or applaud, or support and, instead, we ought to devote some of the vast revenues we are capable of producing here in the United States to helping alleviate that situation and provide some benefits to people who cannot afford them in the private market. And in the course of that, we have destroyed a lot of tenement housing that nobody in their right mind would have suggested somebody live in. You know, we now come to a position where we do not see that kind of stock available in the market. We see a withdrawal of Federal subsidies to subsidize what is in the market. As I say in my statement, sir, the vast majority of low-income people do not face an availability problem. They face an affordability problem, but the Congress has walked away from sorting out its priorities and providing enough money to make that affordability problem go away. And now, in the Tax Code, we are saying let's take away what is left.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman. Mr. Liberty, you made, I thought, a very impressive presentation. Are you suggesting that there ought not to be any changes? One of the problems we have is that every day a different group of people come before this committee and says: You can't change anything that affects us. Are there any changes that you could live with in your business as you have described it here today?

Mr. **Liberty**. Senator Mitchell, in the wake of the huge Federal deficits, which I think must be the top priority of all, or our purposes will have no cause, I think that without question there must be change. And I think there have got to be concessions made by any industry. And I would also like to clarify that I am not just a low-income and rural housing developer, but yet, 60 percent of my activity is in commercial real estate. And I am here today to stress the emphasis that I think that the most devastating of all would be the effect on the low-income industry. The changes that I think would be the most acceptable are the ones that aren't going to impair our ability to raise capital to provide housing. If we are able to raise investor capital through limited partnerships to go toward the cost of housing, in simple terms, without the Government involved with the direct subsidy programs which has made a trend toward getting away from and I think should, without that deep subsidy there have got to be revenue or dollars coming from some other source to reduce the cost of providing this housing, that is, raising the capital through limited partnerships. And if you have the at-risk provisions that are proposed, that would severely impair our ability. It would just, I believe, nullify our being able to raise money. Also, the investment interest deductibility is a major issue. I think that the issues that we can probably live with would be the depreciation extension potentially, not necessarily in low-income housing; but in the commercial industry I certainly think we could. The tax credit does not impair our ability to raise investor capital. It is a useful mechanism. It has been wonderful in redeveloping areas that would not have been redeveloped.

Senator **Mitchell**. Let me interrupt you there because I want to ask a question about the credit, within my limited time. That has been a subject of some discussion. Ms. Oldham, I have visited many of the facilities in Maine; and like other Senators, I have seen the extensive use to which it has been put. But it is obvious that the reason why it has been used so extensively is the overwhelmingly advantageous tax effect it has on those who invest. I mean, to be able to directly reduce one's tax liability by 25 percent of the cost of rehabilitation is an enormous incentive for persons of very high income. Does it not concern you that, admittedly, providing benefits by rehabilitating old buildings—and the reason that Senator Chafee suggested—that it is a principal means by which persons of very high-income are able to avoid completely or largely any tax liability? I mean, you and Mr. Zigas are here saying we have got to help low-income people. Is there no other way to do it, other than by providing other very high-income persons the opportunity to completely avoid paying any taxes, and thereby creating this attitude in our society which is so alarming to the American people? And that is some people are able to avoid taxation almost entirely.

Ms. **Oldham**. I think that it concerns me more, Senator Mitchell, to see the properties around the country rehabilitated which, in the past, were being passed over or being torn down because, if you deal with the Tax Code on a level playing field basis, if you go back and take out this kind of an incentive and out rehabilitation on the same plane with new construction, you will find that rehabilitation projects are not undertaken, and you will find that historic properties are not preserved.

Senator **Mitchell**. Are you saying that the benefit from this is so great that you are willing to accept the subsidiary effect of a relatively small number of persons with very high incomes being able to avoid any taxation whatsoever?

Ms. **Oldham**. I believe that to be the case because——

Senator **Mitchell**. You don't think there is any other way to do it?

Ms. **Oldham**. Having spent 10 years in the field, I haven't seen it done so effectively or efficiently in another way.

Senator **Mitchell**. All right. The tax advantage is so overwhelming that what you are seeing, at least in my State, is a mad scramble to get buildings designated as historic sites; and as we get past the obvious ones in the downtown areas, get them further and further away, and now congressional offices are being deluged with requests from people who say their building got burned down; can you help me get it certified? I mean, is there any end to it? Should this be a permanent thing?

Ms. **Oldham**. I believe that there will be a point in time at which we have—perhaps in terms of the historic resources in this country—listed on the National Register a good number of those that qualify. However, since as time passes additional buildings attain signficance, there won't be a point in time in which we have listed all the properties that ought to qualify. I feel strongly that, within the National Register Program, and I spent 7 years there, that there has not been a change in the types of properties that are now listed on the National Register from those which were listed in the past, in terms of the criteria of the register and how those are applied.

Senator **Mitchell**. My time is up. Thank you.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Mr. Chairman, could we pursue this very interesting conversation with this very attractive panel? I wonder if I could revert to the point that Senator Chafee made about the tendency of people to move out of areas where there is quite adequate infrastructure—an economic infrastructure—and build new housing and new activities on farmlands and cleared lands in the suburbs. What you have here, and the land economist are always talking about it, is an interaction between two sets of economic calculations, that of the private developer who has a set of economic calculations, interacting with the economics of the public sector—the economics of water and sewers and subways and paved streets. And these large investments in infrastructure don't play any role in the decisions of the actual investor in the housing or the shopping mall. In a sense it is an imperfect market. If an investor took all those costs into account, his investment decisions would be quite different. In New York City, the area I am most familiar with, one sees this on a scale without precedent in urban civilization. We have apartments in New York City that have been abandoned that are, with respect, sir, about the size of Portland and surely the size of Providence. And you know, not 20 years ago, half a million persons lived in these neighborhoods, and now almost no one does. The abandoning of these apartments has meant abandoning a subway system and a water system and a street system that are of great and real economic value. I mean, in terms of total costs, we have made wrong economic decisions. One of the results of the rehabilitation credit, particularly since 1981, has been major investment in the rehabilitation of abandoned multistory housing. Some of it was done by private groups, but more often than not, it was done by public groups that solicited the aid of private groups, as I think Ms. Oldham would agree. We were poking along for quite a while in historic preservation, fixing up 18th century houses. They were pretty but they really had very little to do with the urban economy. And we were neglecting two things. In the Housing Act of 1949, we made a huge decision—a mistaken decision—that urban renewal should take the form of simply levelling sections of inner cities, so that people would come in and buy the land at a lower cost and build, and they did. We started knocking down those inner cities at just the moment the suburbs began to grow. We dropped everything. We began this great process of abandonment, which is without an equivalent in the history of human habitation. Then, along came our tax credit, and at some level we restored a more accurate economic calculation as to what is the real benefit of the infrastructure as if it wasn't a real value and build elsewhere. In New York State in 1980, we were running about $100 million worth of rehabilitation a year. We changed the law in 1981. We are now running at $.5 billion a year—all private money producing housing. Ms. Oldham, I am sorry. I didn't mean to take all the time. Isn't that something like it is? I mean, do you recognize this phenomenon?

Ms. **Oldham**. I think there is a tremendously dramatic increase in the amount of activity. I know, in terms of Mr. Packwood's State, that before the 1981 tax incentives were passed, there were five projects that were undertaken from 1976 to 1981, using the historic structures tax incentives. And since 1981, there have been some 85 or 86 projects.

The **Chairman**. And I will bet you could give that figure for every member on the committee. [Laughter.]

Senator **Moynihan**. I just wanted to say, if I can, that something very important has happened here. There are not many things we do in this committee that produce such immediate results.

Senator **Mitchell**. If you make the incentive great enough for people to avoid paying taxes, you will get people engaged in any area of activity.

The **Chairman**. Of course, you will. We encourage them to buy school bonds by making the interest nontaxable, and who buys them? It is is mostly rich people. Now, what is your alternative? Only poor people can buy municipal bonds? [Laughter.]

Senator **Bradley**. Well, there is another factor, a relation here. One, I can't dispute that there has been an increase in rehab housing. The question is: Who is living in that rehab housing? I think there is a real tension between yuppies living in gentrified urban neighborhoods and paying rather sizable rents and low-income housing. And I think this committee has to be clear about that because, if we think what we are doing by rehab tax credits, is providing homes for poor people, I don't think that is happening. I would like to be convinced that it was happening.

Ms. **Oldham**. I would like to make a comment about that.

Senator **Bradley**. And I wonder if it wouldn't be more efficient—and I wonder how the panel would feel about this—if we simply exempted the real estate industry from taxation. Exempt it from taxation. We've been told that that could generate as much as $10 billion a year in revenue. Let's take $5 billion of that and put it into low income housing. What about that?

Ms. **Oldham**. Could I make a comment first? In terms of the use of rehabilitation tax credits for housing, and I have mentioned that there were some 36,000 housing units that had been created, I believe that some 30 to 40 percent of these are for low- and moderate-income people. So, there is a significant number that is, in fact, for low- and moderate-income and not just for upper-income individuals.

Mr. **Shepard**. My project in St. Louis is 30 percent low income.

Senator **Bradley**. You said 30 percent low and moderate?

Mr. **Shepard**. No, not moderate; low income, and 70 percent is market rate.

Senator **Bradley**. When does someone get to moderate income?

Mr. **Shepard**. Moderate income is 80 percent of area median.

Senator **Bradley**. Eighty percent of the area median?

Mr. **Shepard**. Right.

Senator **Bradley**. And you said low income?

Mr. **Shepard**. 80 to 120 percent is considerated median income.

Senator **Bradley**. When does it get to be moderate, Ms. Oldham? You said low and moderate.

Mr. **Shepard**. Low income is under 80 percent. Moderate income is between 80 percent and 120 percent.

Senator **Bradley**. So, you are telling me that, in New Jersey, the median income is, like, say, $24,000? That this goes to people who have an income of $18,000 or under?

Mr. **Shepard**. Well then, there is another category which in the Government programs, I think is 50 percent?, Isn't that now? Very low income is 50 percent, and in my particular project, by definition, we had to go with a 50-percent definition. Those 30 percent of the units in my development are eligible to those people at 50 percent or less of the area median, which is very low-income.

Ms. **Oldham**. In essence, the other units in the building are subsidizing those low-income units.

Senator **Bradley**. Yes.

Mr. **Shepard**. That is exactly right, Senator.

Senator **Bradley**. As I hear the panel, I do think there are really two objectives involved and I believe there is a tension between these two goals, between living in modern facilities but in a neighborhood that looks like our grandparents' and providing adequate housing for people who can't afford it. Now, there is a tension there, and there is a limited pool of resources. I think that we would be mistaken to deny that that kind of tension exists. I would also say that, while housing is clearly a very important part of the budget of low-income people, it is not as if tax reform doesn't do anything for them, particularly if they have kids. It increases the exemptions, the earned income tax credit, and it lowers the rate. So, if they began to earn a little more, they would have more money that they could spend the way they wanted, as opposed to depending upon the Federal Government to subsidize them—or sorry—not subsidize them, subsidize you. I mean, I think that is where it comes down. And given the large number of poor people who don't now have adequate housing despite the tax subsidies to developers, it's only right that we ask whether there isn't a better, more efficient, more equitable way.

Mr. **Cymrot**. Senator? I just wanted to comment that I can appreciate the overriding concern for housing the poor, but rental housing still represents one-third of the American population in its entirety. Furthermore, what I would like to add is that, because of the way the tax structure has been built today, investment in housing is still noncompetitive without taxes. To attempt to change overnight the desirability for people to invest in housing on a competitive basis makes it impossible. Specifically, if I might, in almost all forms of investment, the first and most natural question a person always asks is: What is the bottom line? For better or worse, but that is the way it is. When a person is presented with a real estate investment, the first question is: What is the writeoff? Now, we have set that differential up. It exists because it is necessary. It is necessary because it doesn't compete without the taxes.

Mr. **Liberty**. Senator, if I may make a comment? I think that it would be a major mistake to try to equate the tax credit as an overwhelming means of producing housing or low-income housing to any extent. I think that producing housing and the large production programs have been benefited substantially by limited partnerships and the ability to raise capital. But to suggest that the tax credits or those incentives have been an overwhelming reason for supplying housing or to tie the two together as an equate, I think, is a mistake. I think that I agree with you on that issue totally, and I hate to be inconsistent with my colleagues on that.

Senator Bradley. That only enhances the credibility of the panel.

Mr. Shepard. I agree with Mr. Liberty.

Senator Bradley. In the sense that there is disagreement on the panel.

Mr. Shepard. They really are separate issues and shouldn't be confused, and probably historic rehab and other rehab can be supported on its own merits. I might point out, maybe as a last comment, that the third of America that is in rental housing tends to be, with a very small exception, a slice of luxury renters. The lower income people, and they are the people who would be hurt far and away the most by the proposals in terms of rental increases that would come about.

Mr. Zigas. And Senator, I would make one other point, which is that, with the exception of your proposal, the vast bulk of the subsidies the tax system provides for housing on an untargeted basis to people with high incomes—and the higher your income, the higher your mortgage, and the better off you are—are not proposed for any sort of reform or adjustment whatsoever. And when you are talking about the money that we spend on housing in this country, you don't have to be against it to just make the point that equity in this system does not exist as we know it today. The proposal you are suggesting to free up $10 billion—I would say why only $5 billion—let's put $10 billion into low-income housing, and you will bring us a third or half the way back to where we were in 1981 in terms of budget authority for housing—is certainly one that for the vast majority of low-income renters, putting that money in their pocket to enable them to afford the housing they now have, would solve their problem. There are other issues about building housing and investing in housing that are subsidiary. Right now, the Congress has forced us, I think, to link them together, and I think we would be doing low-income people a great disservice without being able to guarantee a continuing commitment to such a shift. You must be able to say that we are taking this pot of money and shifting it to direct spending for low-income people, and we are going to make sure it stays there so that next year we don't sort of eliminate it for you and leave low-income people hanging on the line to dry. Without that kind of tradeoff, you have an inextricably linked series of incentives here in the Tax Code. If housing can't compete against these other investment opportunities, low-income housing certainly can't compete, in the absence of substantial direct subsidies to make it economical, or the indirect subsidies we have today.

The Chairman. Any other questions?

[No response.]

The Chairman. If not, thank you very much. You are a good panel.

[The prepared written statement of Hon. Richard L. Berkley, mayor of Kansas City, MO, follows:]

Office of the Mayor

Richard L. Berkley, Mayor

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Heart of America

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July 12, 1985

COMMENTS BY RICHARD L. BERKLEY

FOR SENATE FINANCE COMMITTEE

Rehabilitation Tax Credits

Senator Packwood, and members of the Senate Finance Committee, as Mayor of Kansas City, Missouri I am taking this opportunity to share with you the City's concerns with regards to the possible repeal of the Incentive Tax Credits for Historic Preservation.

I only wish that each of you could have the opportunity to actually observe the impact that the rehabilitation of Certified Historic Buildings have made on Kansas City's urban fabric. Over $200 million is being invested in rehabilitation, with the greatest investment located in the Central Business District. This impressive investment in our architectural heritage is being partnered with a new construction boom that will return the lost vitality to our downtown area.

Each of the projects that unite the old with the new are exciting. For not only will the visual elements reveal the significant old combined with sensitive new construction, but the long sought after partnership of public and private dollars is occurring. This, at any governmental level, is economics at its best.

As an elected official I know the financial savings that come from being able to use an already in place infrastructure of existing utilities, sewers and streets. This infrastructure exists within the redevelopment areas.

Two National Register of Historic Places districts, the Quality Hill Historic District and the Wholesale Historic District, where development projects are underway, comprise nearly 25% of the total land area of Kansas City's Business District. For years these areas have suffered from the blight created by urban flight. The investment of city services in these two areas, prompted by their decline, to fight fires, to provide police protection, to contend with the amount of litter that is created in and around abandoned buildings, has been considerable. The successful revitalization of these areas will prevent these costly excesses to control crime and neglect.

The $36 million redevelopment project in Quality Hill is the combined financial undertaking of an experienced developer from St. Louis, McCormack Baron & Associates, the City of Kansas City, Missouri, numerous local corporations and philanthropic institutions, banks, the Department of Housing and Urban Development, the Kansas City Redevelopment Authority, and others. This complex yet functional partnership will be responsible for the creation of 178 permanent jobs, 330 construction jobs, approximately one-half million dollars in construction sales tax, $45.790 in Kansas City earnings tax plus personal, state and federal income taxes. This project would NOT have been economically feasible without the federal tax credits.

Individual buildings that have been deemed significant, have also been saved and returned to income producing entities. The repealing of these tax credits for rehabilitation would once again adversely increase the odds on the final solution being the demolition of a recyclable building into a surface parking lot.

The benefits that can be realized through the creative and resourceful use of the Investment Tax Credits have not as yet attained their maximum potential in Kansas City. The repeal of the credits would close the redevelopment doors on the Market Area Redevelopment Project. This particular area is a vital connection to the Central Business District, as well as having its own important and distinct history. The implementation of the plans for this National Register historic district will result in up to $30 million in rehabilitation construction within the next three years. Over 1,500 new, permanent jobs will result and another 1,000 jobs will be retained. These, we believe, are impressive figures.

The 18th and Vine Street Historic District's revitalization is dependent on the retention of the tax credits. This area is internationally recognized as the birthplace of Kansas City Jazz. The income producing capacities of this revitalized area would be substantial not for just a short term but over a significant period of time.

Over a period of years, many federally designed and funded programs have been devised in an attempt to find answers to the urban problems that have plagued our cities. The tax credits rehabilitation, in my estimation, is a program that has really worked. The low-interest loan programs, Urban Renewal, EDA, and other efforts have not been as effective. There is no substitute for the tax credits for rehabilitation. This is the successful marriage of public funds with private money, and this private money is invested at risk.

The retention of the tax credits will also provide the incentive for the rehabilitation of other older buildings located in problem neighborhoods. The use of the 15% and 20% tax incentives can well act as preventive measures to insure that structurally sound buildings are put to adaptive reuse before they are permantly abandoned. School and hospital buildings are good examples. Many such buildings can be recycled for residential and/or office use.

I recently returned from the U.S. Conference of Mayors meeting. There is a strong desire to retain the tax credits for historic preservation. The value of these credits are significant to mayors.

I cannot be sufficiently emphatic in stressing to you how vital these tax credits have been and are to economic redevelopment of our blighted urban areas. The ultimate success of the projects that are presently underway is dependent on the ability to complete aforementioned project areas. Deterioration and visual blight immediately adjacent to revitalized areas can only provide the elements that lead to continuing urban decay. The retention of the tax credits are imperative to Kansas City's continued economic renaissance. This success is just within our grasp but only if the tax credits remain as the prime incentive.

Richard L. Berkley
Mayor, Kansas City, Missouri

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

AMERICAN
CANCER
SOCIETY
NATIONAL OFFICE

STATEMENT OF

THEODORE C. MARRS, M.D.

NATIONAL BOARD OF DIRECTORS,
AMERICAN CANCER SOCIETY

MEMBER, NATIONAL PUBLIC ISSUES COMMITTEE
AMERICAN CANCER SOCIETY

PRESIDENT, NEW MEXICO DIVISION
AMERICAN CANCER SOCIETY

ON BEHALF OF THE
AMERICAN CANCER SOCIETY

REGARDING THE IMPACT OF THE ADMINISTRATION'S TAX REFORM PROPOSAL ON CHARITABLE GIVING

BEFORE THE
COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 9, 1985

AMERICAN CANCER SOCIETY, INC.
90 PARK AVENUE, NEW YORK, N.Y. 10016 • 212-599-8200

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Mr. Chairman, Members of this Distinguished Committee, my name is Theodore C. Marrs, M.D., and I am submitting testimony for your consideration, on behalf of the American Cancer Society, the largest nonprofit health agency in the world. Last year, the two and one-quarter million volunteers of the Society raised $250 million for research; public and professional education; and service and rehabilitation programs to fight cancer. The Society serves residents in all 50 states, Puerto Rico and Guam. We do not receive, nor do we solicit government monies -- and frankly we relish our private sector role.

You have heard testimony from some of the Society's sister organizations on the impact of proposed changes in the tax code that would affect us all! I submit my testimony for your consideration as well.

The American Cancer Society has no position on general tax reform or simplification. We believe that Congress, with all this information, looking at the total package, will make the right decision concerning changes in the tax code. However, the ACS does have a position on certain provisions in Treasury II that would affect our ability to provide programs and services to cancer patients and our research efforts to battle this terrible disease.

By far the greatest motivation for donation to such organizations as ours is the desire to serve. No less true is the fact that donors expect and deserve their hard gained rights to retain a full deduction for genuine charitable contributions. Correction of any misuse of this long-held privilege should be controlled not by withdrawal of deduction privileges, but by realistic evaluation of charitable organizations including consideration of their necessary overhead, their research funding, their patient services and their educational effectiveness. The American Cancer Society would welcome this -- in contrast with some of the fly-by-night fundraisers.

Within the past two weeks our National Board -- made up of equal numbers of highly qualified physicians and prominent and responsible lay people -- passed a resolution asking support for "the rights of all Americans, whether or not they itemize their deductions, to deduct all charitable contributions and to amend the tax reform proposal to remove the clause calling for repeal of the Charitable Contributions Law." That resolution is submitted as a part of my testimony.

Already, about one-third of the Members in the Senate have cosponsored S. 361, which would accomplish our objective; we believe this resolution should become law.

When you consider the dollar impact of taking the action we request, please consider that, within the past ten days, ACS has authorized an additional $35.7 million dollars for specific clinical investigation and research activities during our next budget year, plus additional funding to combat cancer quackery, extend educational efforts, advance the worldwide fight against cancer and enhance early detection and treatment (including cost reduction) procedures.

Neither you nor the Administration budgeters can really want to take the action which has been proposed. You cannot possibly want to deprive our citizens of this small compensation for serving their fellows who are less fortunate -- to deprive many of what has become their *personal* opportunity to combat the major killing diseases.

And, despite the desire to participate as we combat cancer, heart disease and lung disease, there are many who *cannot* do so without that deduction for nonitemizers, which we seek. There are even a few who will say "let the government do it" if they cannot deduct their contribution -- and the research, education and service programs of the great volunteer organizations will be significantly damaged. No less severe will be the impact on the small foundations which serve special causes in my home town and yours -- small organizations such as All Faiths which serves abused and abandoned children in Albuquerque and which is multiplied by thousands in your home state. For them too, the American Cancer Society presumes to speak.

Let me close by asking that this Committee recommend to retain the charitable deduction for itemizers and nonitemizers alike. Any changes in the law, short of this, would cause severe hardship for the people served by private sector organizations dependent on contributions from the public. It would also be viewed as governmental non-support of the right to give.

I would like to submit for the record the American Cancer Society's latest Annual Report and a copy of the 1985 Cancer Facts and Figures, which should be available to all Members of the United States Congress.

AMERICAN CANCER SOCIETY
NATIONAL OFFICE

For more information contact:
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AMERICAN CANCER SOCIETY
POSITION STATEMENT

CHARITABLE CONTRIBUTIONS LAW

In consideration of a position statement on tax reform and the Charitable Contributions Law the National Board of Directors, American Cancer Society recommends the following:

> **WHEREAS**, While the Administration's tax reform proposal, announced by President Reagan on May 28, retains full deduction of charitable contributions for those who itemize their deductions, it calls for repeal of the Charitable Contributions Law denying the 85% of taxpayers who would be expected to file the short form -- and not itemize -- under the Administration plan, the right to deduct their charitable contributions above the line, and
>
> **WHEREAS**, A long held policy goal of the Society -- the achievement through legislation of the right of non-itemizers to deduct their charitable contributions above the line realized in passage of the Charitable Contributions Law in 1981 and scheduled for full implementation in 1986, is now threatened by repeal under the Administration's tax plan, and
>
> **WHEREAS**, By reducing the percentage of taxpayers eligible to deduct charitable contributions from 100% to 15%, charitable giving is expected to decrease by $5.6 billion causing severe hardship for the people and the institutions served by private sector organizations depending on contributions from the public.
>
> **NOW, THEREFORE, BE IT RESOLVED**: That the American Cancer Society urges the President to support the right of all Americans, whether or not they itemize their deductions, to deduct all charitable contributions and to amend his tax reform proposal to remove the clause calling for repeal of the Charitable Contributions Law.

Los Angeles, Calfornia
June 28, 1985

"CHLIGHTS THIS YEAR:
- New cancer survival rates
- Nutrition and cancer
- Cancer prevention

1985 CANCER FACTS & FIGURES

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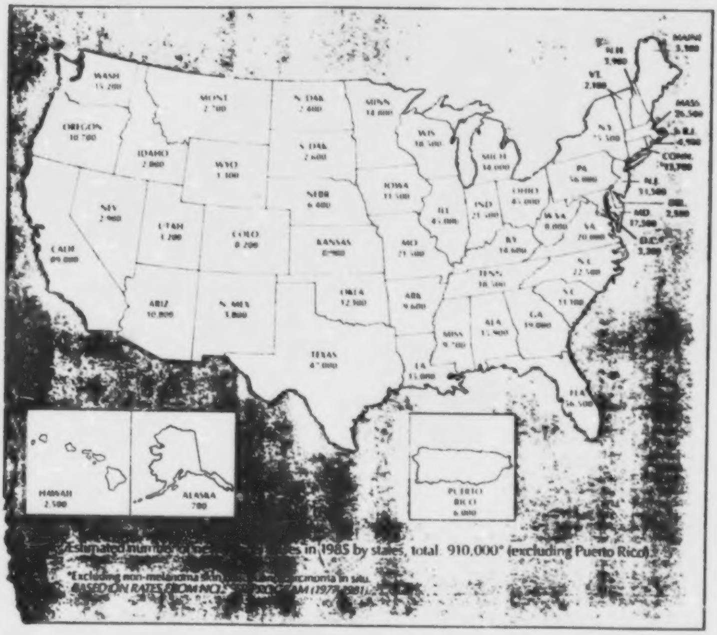

Estimated number of ne[illegible]es in 1985 by states, total 910,000* (excluding Puerto Rico).

*Excluding non-melanoma skin [illegible] carcinoma in situ.
BASED ON RATES FROM NCI [illegible] PROGRAM (1973-1981).

CANCER: BASIC DATA

BASIC DATA

What is cancer?

Cancer is a large group of diseases characterized by uncontrolled growth and spread of abnormal cells. If the spread is not controlled or checked, it results in death. However, many cancers can be cured if detected and treated promptly.

How is cancer treated?

By surgery, X rays, radioactive substances, chemicals, hormones and immunotherapy.

Who gets cancer?

Cancer strikes at any age. It kills more children 3 to 14 than any other disease. And cancer strikes more frequently with advancing age. In the 1970's, there were an estimated 3.5 million cancer deaths, over 6.5 million new cancer cases, and more than 10 million people under medical care for cancer.

How many people alive today will get cancer?

About 71 million Americans now living will eventually have cancer, about 30%, according to present rates. Over the years, cancer will strike in approximately three out of four families.

How many people alive today have ever had cancer?

There are over 5 million Americans alive today who have a history of cancer, 3 million of them with diagnosis five or more years ago. Most of these 3 million can be considered cured, while others still have evidence of cancer. By "cured" is meant that a patient has no evidence of disease and has the same life expectancy as a person who never had cancer.

The decision as to when a patient may be considered cured is one that must be made by the physician after examining the individual patient. For most forms of cancer, five years without symptoms following treatment is the accepted time. However, some patients can be considered cured after one year, others after three years, whereas some have to be followed much longer than five years.

How many new cases will there be this year?

In 1985 about 910,000 people will be diagnosed as having cancer.*

How many people are surviving cancer?

In the early 1900's few cancer patients had any hope of long-term survival. In the 1930's less than one in five was alive at least five years after treatment. In the 1940's it was one in four, and in the 1960's it was one in three.

Today, about 340,000 Americans, or 3 out of 8 patients who get cancer this year, will be alive 5 years after diagnosis. The gain from 1 in 3 to 3 in 8 represents about 50,000 persons this year. This 3 in 8, or about 39% is called the "observed" survival rate. When normal life expectancy is taken into consideration (factors such as dying of heart disease, accidents and diseases of old age) 49% will be alive 5 years after diagnosis. This is the "relative" survival rate, and is considered a more accurate yardstick of our battle against cancer.

Could more people be saved?

Yes. About 160,000 people with cancer will probably die in 1985 who might have been saved by earlier diagnosis and prompt treatment.

How many people will die?

This year about 462,000 will die of the disease — 1,266 people a day, about one every 68 seconds. Of every five deaths from all causes in the U.S., one is from cancer. In 1984 an estimated 452,000 Americans died of cancer. In 1983 it was 442,000, in 1982 the figure was 432,000.

What is the national death rate?

There has been a steady rise in the age-adjusted** national death rate. In 1930 the number of cancer deaths per 100,000 population was 143. In 1940 it was 152. By 1950 it had risen to 158 and in 1981 the number was 167. The major cause of these increases has been cancer of the lung. Except for that form of cancer, age-adjusted cancer death rates for major sites are leveling off, and in some cases declining.

Can cancer be prevented?

Some cancers, not all. Most lung cancers are caused by cigarette smoking, and most skin cancers by frequent overexposure to direct sunlight. These cancers can be prevented by avoiding their causes. Certain cancers caused by occupational-environmental factors can be prevented by eliminating or reducing contact with carcinogenic agents. See Prevention section, pp. 17-20.

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*These estimates of the incidence of cancer are based upon data from the National Cancer Institute's SEER Program (1977-1981). Non-melanoma skin cancer and carcinoma in situ have not been included in the statistics. The incidence of non-melanoma skin cancer is estimated to be over 400,000.

**Age-adjusted — a method used to make valid statistical comparisons by assuming the same age distribution among different groups being compared.

HOW CANCER WORKS

Normally, the cells that make up the body reproduce themselves in an orderly manner so that worn-out tissues are replaced, injuries are repaired and growth of the body proceeds.

Occasionally, certain cells undergo an abnormal change and begin a process of uncontrolled growth and spread. One cell divides into two, those redivide into four, and so on. These cells may grow into masses of tissue called tumors — some benign and others malignant (cancerous).

The danger of cancer is that it invades and destroys normal tissue. At the beginning, cancer cells usually remain at their original site, and the cancer is said to be localized. Later, some cancer cells may invade neighboring organs or tissue. This occurs either by direct extension of growth or by becoming detached and carried through the lymph or blood systems to other parts of the body. This is called metastasis of a cancer.

This spread may be regional — confined to one region of the body — when cells are trapped by lymph nodes. If left untreated, however, the cancer is likely to spread throughout the body. That condition is known as advanced cancer, and usually results in death.

Because a case of cancer becomes progressively more serious with each stage, it is important to detect cancer as early as possible. Aids to early detection include cancer's Seven Warning Signals and the cancer risk factors.

TRENDS IN DIAGNOSIS AND TREATMENT

Cancer management today is becoming increasingly individualized both with respect to diagnostic procedures and treatment. Early detection is followed by a precise staging of the disease, and the use of more than one kind of therapy, often in combination.

A number of cancers, which only a few decades ago had very poor prognoses, are today being cured in many cases: acute lymphocytic leukemia in children, Hodgkin's disease, Burkitt's lymphoma, Ewing's sarcoma (a form of bone cancer), Wilms' tumor (a form of kidney cancer in children), rhabdomyosarcoma (a cancer that forms in certain muscle tissue), choriocarcinoma (placental cancer), testicular cancer, ovarian cancer and osteogenic sarcoma. Other cancers are being more effectively controlled than in the past.

An outstanding example of progress is the improvement in the management of testicular cancer in young men. Better disease staging in certain cases, and the use of new and improved combinations of cancer drugs has resulted in remarkably improved survival. In less than 20 years, the five-year survival rate for all cases rose from 63% to 82% for these cancers.

The following developments indicate the directions of current and future research:

- A genetic fusing of cancer cells can produce disease-fighting "monoclonal antibodies" — specific antibodies tailored to seek out chosen targets on cancer cells. The potential that monoclonal antibodies can be used in the diagnosis and treatment of cancer is under study.
- A series of chemical injections near the spine can act as a nerve block, relieving certain cancer patients of debilitating pain. Understanding the effect of available analgesics has made the control of chronic pain more effective. Using oral pain medicine on a regular basis can relieve pain for most cancer patients.
- Chemoprevention studies with agents like synthetic retinoids (cousins of Vitamin A), betacarotene, folic acid, and other vitamins and minerals are being undertaken to see if recurrences of certain cancers can be prevented. The next step is to see if these agents can reduce cancer in high risk persons. Studies of dietary intervention will examine the effect of low-fat diets in women with stage II breast cancer.
- About fifty drugs have been found effective against certain cancers, and others that are still being tested hold promise.
- Many patients with bone cancer now are treated successfully by removing and replacing a section of bone rather than by amputating the leg or arm. Drugs and radiation therapy are being used effectively following surgery, resulting in dramatic improvement in survival.
- Computerized tomography (CT scanning) uses X rays to examine the brain and other parts of the body. Cross-section pictures are constructed which show a tumor's shape and location more accurately than is possible with conventional x-ray techniques.

  For patients undergoing radiation therapy, CT Scanning may enable the therapist to pinpoint the tumor more precisely in order to provide more accurate radiation dosage while sparing normal tissue.
- Immunotherapy holds hope of harnessing the body's own disease-fighting systems to combat cancer with minimal toxicity.
- Many cancers are caused by a two-stage process through exposure to two different kinds of substances known as initiators and promotors. Researchers are exploring ways of interrupting the process, thereby preventing the development of cancer.
- The transfusion of blood components is becoming increasingly available and effective as a support in cancer therapy. Platelets are used to prevent hemorrhaging, and red blood cells to combat anemia. The control of infection, a common complication in cancer patients, can be better controlled due to new understanding of antibiotic treatment and newer antibodies.
- New technologies have made it possible to use bone marrow transplantation as an important treatment option in selected patients with leukemia and aplastic

anemia. Its effect in other cancers is being studied.

- Hyperthermia, the use of heat to kill cancer cells, may play a vital role in future cancer treatment. Hyperthermia is being studied in combination with radiation therapy or chemotherapeutic drugs to determine if a synergistic response can be produced.
- With medical progress producing longer survival periods for cancer patients, clinical concerns are expanding to include not only patients' physical well-being, but also their psychosocial needs. The patient's and family's reactions to the disease, sexual concerns, employment and insurance needs and ways to provide psychosocial support have emerged as important areas of research and clinical care.
- Nuclear Magnetic Resonance (NMR) is another noninvasive imaging technique. It uses a huge electromagnet to detect tumors by sensing the vibrations of the different atoms in the body. NMR could revolutionize the diagnosis of cancer and other diseases.
- HTLV (human T-cell leukemia virus) is believed by many to be the first bona fide cancer virus in humans. This discovery has made possible the detection of antibodies in people who may be at high risk to a particular leukemia. It is hoped that soon a vaccine can be made to prevent this type of cancer.
- Breast reconstruction can be an important rehabilitation choice for women who have had a mastectomy for breast cancer.
- Intraoperative radiation is being studied as a way to give x-ray treatment at the time of surgery. The technique can give doses of X ray directly to the tumor and may be able to eliminate residual cancer cells.
- Improvements in chemotherapy, radiation therapy and surgical techniques have made possible more conservative management of early cancers. This has meant in the case of early larynx cancers that many patients have been able to retain their voice, and in colorectal cancers fewer permanent colostomies are needed.
- Techniques such as thermography (heat patterns), ultrasound (high-frequency sound waves) and diaphonoscopy (inspection with a beam of light) are currently being studied for their possible effectiveness and appropriate use in detecting early breast cancer.

HOW TO ESTIMATE CANCER STATISTICS LOCALLY

Community Population	Estimated No. Who are Alive, Saved from Cancer	Estimated No. Cancer Cases Under Medical Care in 1985	Estimated No. Who Will Die of Cancer in 1985	Estimated No. of New Cases in 1985	Estimated No. Who Will be Saved from Cancer in 1985	Estimated No. Who Will Eventually Develop Cancer	Estimated No. Who Will Die of Cancer if Present Rates Continue
1,000	10	5	1	3	1	280	180
2,000	20	11	4	7	3	560	360
3,000	30	16	5	10	4	840	540
4,000	40	21	7	13	5	1,120	720
5,000	50	26	9	16	6	1,400	900
10,000	100	52	18	33	12	2,800	1,800
25,000	250	131	45	79	30	7,000	4,500
50,000	500	162	90	158	59	14,000	9,000
100,000	1,000	525	180	325	122	28,000	18,000
200,000	2,000	1,050	360	650	244	56,000	36,000
500,000	5,000	2,625	900	1,575	590	140,000	90,000

NOTE: The figures can only be the roughest approximation of actual data for your community and should be used with caution. It is suggested that every effort be made to obtain actual data from a Registry source.

NEW CANCER CASES — 1985

Estimated New Cancer Cases for All Sites Plus Major Sites, by State — 1985

	ALL SITES*	MAJOR SITES								
STATE	Number of Cases	Female Breast	Colon-Rectum	Lung	Oral	Uterus	Prostate	Stomach	Pancreas	Leukemia
Alabama	15,900	1,700	1,800	2,700	425	1,100	1,700	350	425	450
Alaska	700	75	90	125	15	25	75	30	10	20
Arizona	10,800	1,300	1,500	1,800	275	525	1,000	200	250	225
Arkansas	9,600	1,000	1,200	1,700	300	600	1,100	200	300	300
California	89,000	12,200	13,100	14,100	2,800	4,000	8,300	2,700	2,600	2,500
Colorado	8,200	1,000	1,200	1,200	200	400	800	200	250	250
Connecticut	13,700	2,300	2,100	1,900	500	750	1,400	400	400	400
Delaware	2,500	325	375	400	80	150	200	60	50	40
Dist. of Columbia	3,200	450	400	450	200	275	375	100	100	60
Florida	56,500	6,600	8,200	9,500	1,900	2,800	5,800	1,300	1,400	1,400
Georgia	19,000	2,000	2,300	3,300	700	1,200	2,000	400	450	500
Hawaii	2,500	325	350	400	100	100	175	200	60	70
Idaho	2,800	475	325	375	75	150	275	70	80	100
Illinois	45,000	6,200	7,200	7,300	1,600	2,500	3,800	1,400	1,300	1,300
Indiana	21,500	2,900	3,400	3,600	500	1,600	1,900	450	550	550
Iowa	11,500	1,500	2,500	1,700	300	600	1,200	300	350	400
Kansas	8,900	1,200	1,400	1,600	275	500	900	200	300	300
Kentucky	14,600	1,500	2,100	2,800	475	750	1,200	300	375	400
Louisiana	15,000	1,700	2,100	2,500	550	950	1,400	400	400	425
Maine	5,300	600	800	850	175	300	400	150	150	100
Maryland	17,500	2,600	2,800	2,900	700	1,000	1,500	400	400	400
Massachusetts	26,500	3,700	4,200	3,600	1,000	1,300	2,300	850	650	700
Michigan	34,000	4,400	4,900	5,500	1,000	2,000	3,500	900	850	950
Minnesota	14,800	2,100	2,400	2,000	375	800	1,600	500	450	500
Mississippi	9,700	900	1,300	1,600	275	600	1,100	275	300	300
Missouri	21,500	2,500	3,300	3,600	550	1,300	2,100	500	550	600
Montana	2,700	300	400	400	80	150	400	80	80	80
Nebraska	6,400	800	1,100	900	150	300	700	175	225	225
Nevada	2,900	325	350	550	70	150	200	20	60	40
New Hampshire	3,900	500	650	550	100	225	325	75	90	125
New Jersey	33,500	4,900	5,400	5,100	1,100	2,100	3,000	1,200	900	850
New Mexico	3,800	450	500	500	70	250	375	90	90	70
New York	75,500	11,900	13,000	10,900	2,700	4,700	6,700	2,800	2,400	2,100
North Carolina	22,500	2,800	3,000	3,500	750	1,400	2,400	425	600	500
North Dakota	2,400	375	425	275	60	125	300	100	80	70
Ohio	45,000	6,300	7,100	7,300	1,500	2,800	4,100	1,200	1,300	1,400
Oklahoma	12,100	1,300	1,900	2,200	375	600	1,100	300	325	325
Oregon	10,700	1,300	1,400	1,800	250	550	1,000	225	300	300
Pennsylvania	56,000	7,500	10,200	8,100	1,700	3,000	4,800	1,600	1,500	1,400
Rhode Island	4,900	650	950	700	225	250	400	200	150	80
South Carolina	11,100	1,300	1,400	1,800	350	500	1,200	200	300	250
South Dakota	2,600	425	475	400	50	125	300	80	90	100
Tennessee	18,500	2,000	2,600	3,300	550	1,100	1,600	350	500	500
Texas	47,000	5,600	6,100	7,600	1,600	2,600	4,200	1,300	1,200	1,500
Utah	3,200	475	425	275	70	175	400	80	80	80
Vermont	2,100	250	325	350	60	125	200	50	50	60
Virginia	20,000	2,400	2,600	3,400	600	1,100	2,100	425	475	450
Washington	15,200	850	2,200	2,600	475	800	1,400	375	425	475
West Virginia	8,000	2,100	1,000	1,400	200	550	650	200	250	200
Wisconsin	18,500	2,500	3,000	2,400	550	900	1,900	600	500	550
Wyoming	1,300	150	200	200	20	50	150	25	30	30
United States	910,000	119,000	138,000	144,000	29,000	52,000	86,000	25,000	25,000	25,000
Puerto Rico	6,000	450	450	350	425	750	400	500	100	175

* Does not include carcinoma in situ or non-melanoma skin cancer.

These estimates are offered as a rough guide and should not be regarded as definitive. They are calculated according to the distribution of estimated 1985 cancer deaths by state. Especially note that year-to-year changes may only represent improvements in the basic data.

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CANCER DEATHS — 1985
Estimated Cancer Deaths for All Sites Plus Major Sites, by State — 1985

STATE	ALL SITES Number of Deaths	ALL SITES Death Rate per 100,000 Population	MAJOR SITES Female Breast	Colon-Rectum	Lung	Oral	Uterus	Prostate	Stomach	Pancreas	Leukemia
Alabama	8,000	197	550	800	2,400	125	200	425	200	400	300
Alaska	400	87	30	30	100	5	10	10	10	10	10
Arizona	5,500	164	400	600	1,700	100	50	250	125	250	175
Arkansas	4,900	201	325	550	1,700	100	100	300	150	275	225
California	45,600	178	3,800	5,600	12,600	850	900	2,400	1,500	2,400	1,700
Colorado	4,200	126	375	550	1,200	70	70	250	125	225	175
Connecticut	7,000	224	650	900	1,800	175	125	350	250	375	275
Delaware	1,300	212	100	200	325	25	20	60	30	60	40
Dist. of Columbia	1,600	281	175	200	375	75	60	100	60	100	40
Florida	29,000	252	2,200	3,600	8,000	450	400	1,600	800	1,500	850
Georgia	9,400	162	650	950	3,000	200	250	500	225	475	350
Hawaii	1,300	124	80	150	300	30	20	50	90	70	50
Idaho	1,500	139	125	150	300	25	25	90	40	75	70
Illinois	23,200	202	2,000	3,200	6,100	500	600	1,200	750	1,300	900
Indiana	11,000	197	950	1,500	3,200	200	300	550	250	550	425
Iowa	5,800	197	500	1,000	1,600	100	125	400	150	325	300
Kansas	4,700	195	425	650	1,500	100	100	300	125	250	200
Kentucky	7,500	194	500	950	2,500	175	175	400	150	375	275
Louisiana	7,800	174	550	850	2,300	175	175	450	250	450	300
Maine	2,600	221	225	350	650	50	60	150	90	150	80
Maryland	8,800	202	700	1,200	2,700	200	175	450	225	400	275
Massachusetts	13,100	229	1,200	2,000	3,300	325	275	650	500	650	450
Michigan	17,200	184	1,400	2,200	4,600	325	400	950	475	850	650
Minnesota	7,500	177	650	1,000	1,900	150	125	500	250	425	350
Mississippi	4,800	182	325	550	1,500	90	100	350	125	300	200
Missouri	10,800	216	800	1,400	3,000	200	250	600	275	500	400
Montana	1,400	167	100	175	350	30	30	125	50	90	60
Nebraska	3,300	206	275	500	800	60	70	225	125	200	175
Nevada	1,500	145	100	150	400	25	20	50	10	70	30
New Hampshire	2,000	194	175	300	425	40	40	90	40	90	70
New Jersey	17,000	229	1,600	2,400	4,300	350	375	850	650	850	550
New Mexico	1,900	134	150	200	375	25	40	90	50	100	60
New York	35,400	226	4,000	5,800	9,400	850	950	1,900	1,600	2,100	1,400
North Carolina	11,200	181	800	1,200	3,000	225	275	650	250	500	400
North Dakota	1,200	180	100	175	225	20	20	90	60	80	50
Ohio	22,900	212	1,900	3,100	6,100	425	600	1,200	650	1,200	800
Oklahoma	6,100	187	425	800	2,000	100	100	350	150	300	250
Oregon	5,300	178	400	600	1,600	100	75	325	125	275	200
Pennsylvania	28,200	239	2,400	4,300	6,800	500	700	1,400	850	1,400	950
Rhode Island	2,500	263	250	400	600	60	40	150	100	100	70
South Carolina	5,600	168	400	550	1,600	100	125	325	125	300	175
South Dakota	1,400	202	125	200	300	20	30	100	50	100	80
Tennessee	9,300	192	600	1,000	2,800	200	200	475	225	450	325
Texas	23,700	149	1,700	2,600	6,700	425	500	1,100	700	1,300	1,000
Utah	1,600	91	150	175	225	20	30	100	50	80	70
Vermont	1,100	203	90	150	275	20	30	70	30	50	40
Virginia	10,000	177	750	1,200	3,000	175	225	500	250	475	325
Washington	7,700	168	600	950	2,400	150	150	425	200	400	300
West Virginia	4,100	206	275	475	1,300	75	100	225	100	200	150
Wisconsin	9,400	193	900	1,400	2,200	175	175	600	325	500	375
Wyoming	700	119	50	70	175	10	10	50	15	50	30
United States	462,000	194	38,000	60,000	126,000	9,000	10,000	25,000	14,000	24,000	17,000
Puerto Rico	3,000	94	125	125	300	175	150	225	400	100	150

ESTIMATED NEW CANCER CASES AND DEATHS BY SEX FOR ALL SITES—1985*

	ESTIMATED NEW CASES			ESTIMATED DEATHS		
	Both Sexes	Male	Female	Both Sexes	Male	Female
ALL SITES	910,000*	455,000*	455,000*	462,000	249,000	213,000
Buccal Cavity & Pharynx (ORAL)	28,900	19,500	9,400	9,500	6,450	3,050
Lip	4,500	4,000	500	175	150	25
Tongue	5,200	3,300	1,900	2,050	1,400	650
Mouth	10,400	6,100	4,300	2,975	1,900	1,075
Pharynx	8,800	6,100	2,700	4,300	3,000	1,300
Digestive Organs	215,200	109,500	105,700	119,800	62,600	57,200
Esophagus	9,400	6,600	2,800	8,800	6,400	2,400
Stomach	24,700	15,000	9,700	14,300	8,400	5,900
Small Intestine	2,200	1,100	1,100	800	400	400
Large Intestine } (COLON-RECTUM)	96,000	44,000	52,000	51,600	24,600	27,000
Rectum	42,000	22,000	20,000	8,300	4,400	3,900
Liver & Biliary Passages	13,400	6,700	6,700	10,400	5,200	5,200
Pancreas	25,200	13,000	12,200	24,200	12,500	11,700
Other & Unspecified Digestive	2,300	1,100	1,200	1,400	700	700
Respiratory System	159,200	110,100	49,100	130,650	90,900	39,750
Larynx	11,500	9,500	2,000	3,750	3,100	650
LUNG	144,000	98,000	46,000	125,600	87,000	38,600
Other & Unspecified Respiratory	3,700	2,600	1,100	1,300	800	500
Bone	2,000	1,100	900	1,400	800	600
Connective Tissue	5,000	2,700	2,300	2,800	1,300	1,500
SKIN	22,000**	11,000**	11,000**	7,400†	4,400	3,000
BREAST	119,900***	900***	119,000***	38,700	300	38,400
Genital Organs	167,200	92,300	74,900	48,850	26,450	22,400
Cervix Uteri } (UTERUS)	15,000***	—	15,000***	6,800	—	6,800
Corpus, Endometrium	37,000	—	37,000	2,900	—	[illegible]
Ovary	18,500	—	18,500	11,600	—	11,600
Other & Unspecified Genital, Female	4,400	—	4,400	1,100	—	1,100
Prostate	86,000	86,000	—	25,500	25,500	—
Testis	5,000	5,000	—	500	500	—
Other & Unspecified Genital, Male	1,300	1,300	—	450	450	—
Urinary Organs	59,700	41,500	18,200	19,700	12,700	7,000
Bladder	40,000	[illegible]	11,000	10,800	7,300	3,500
Kidney & Other Urinary	19,700	12,500	7,200	8,900	5,400	3,500
Eye	1,800	900	900	400	200	200
Brain & Central Nervous System	13,700	7,700	6,000	10,100	5,500	4,600
Endocrine Glands	11,700	3,500	8,200	1,700	700	1,000
Thyroid	10,600	2,900	7,700	1,100	400	700
Other Endocrine	1,100	600	500	600	300	300
Leukemias	24,600	13,600	11,000	17,200	9,500	7,700
Lymphocytic Leukemia	11,800	6,700	5,100	6,500	3,800	2,700
Granulocytic Leukemia	12,100	6,500	5,600	10,300	5,500	4,800
Monocytic Leukemia	700	400	300	400	200	200
Other Blood & Lymph Tissues	41,300	22,400	20,900	22,300	11,500	10,800
Hodgkin's Disease	6,900	3,900	3,000	1,500	900	600
Multiple Myeloma	9,900	5,000	4,900	7,400	3,800	3,600
Other Lymphomas	26,500	13,500	13,000	13,400	6,800	6,600
All Other & Unspecified Sites	35,800	18,300	17,500	31,500	15,700	15,800

NOTE: The estimates of new cancer cases are offered as a rough guide and should not be regarded as definitive. Especially note that year-to-year changes may only represent improvements in the basic data. ACS six major sites in boldface caps.

*Carcinoma in situ and non-melanoma skin cancers not included in totals. Carcinoma in situ of the uterine cervix accounts for over 45,000 new cases annually and carcinoma in situ of the female breast accounts for over 5,000 new cases annually. Non-melanoma skin cancer accounts for over 400,000 new cases annually.

**Melanoma only.

***Invasive cancer only.

INCIDENCE ESTIMATES ARE BASED ON RATES FROM NCI SEER PROGRAM 1977-1981.

MAJOR CANCER SITES

LUNG CANCER

Incidence: An estimated 144,000 new cases in 1985.

Mortality: An estimated 126,000 deaths in 1985. The age-standardized lung cancer death rate for women is more than that of colorectal cancer, and by 1986 will surpass breast cancer to become the number one cancer killer of women. Those who smoke two or more packs of cigarettes a day have lung cancer mortality rates 15 to 25 times greater than nonsmokers, according to the 1982 Surgeon General's Report.

Warning Signals: A persistent cough; sputum streaked with blood; chest pain; recurring attacks of pneumonia or bronchitis.

Risk Factors: Cigarette smoking, history of smoking 20 or more years; exposure to certain industrial substances such as asbestos, particularly for those who smoke.

Early Detection: Lung cancer is very difficult to detect early; symptoms often don't appear until the disease has advanced considerably. If a smoker quits at the time of early precancerous cellular changes, the damaged bronchial lining often returns to normal. If a smoker continues the habit, cells may form abnormal growth patterns that lead to cancer. Diagnosis may be aided by such procedures as the chest X ray, sputum cytology test and fiberoptic bronchoscopy.

Treatment: Treatment depends on the type of, and stage of lung cancer. Surgery, radiation therapy and chemotherapy are all options. For many localized cancers, surgery is usually the treatment of choice. Since the majority of patients with lung cancer have tumor spread, radiation therapy and chemotherapy are often combined with surgery. In small cell cancer of the lung, chemotherapy alone or combined with radiation has largely replaced surgery as the treatment of choice, with a large percentage of patients experiencing remission — in some cases, long-lasting remission.

Survival: Only 13% of lung cancer patients (all stages, whites and blacks) live five or more years after diagnosis. The rate is 40% for cases detected in a localized stage; 20% of lung cancers are discovered that early. Rates have improved only slightly over a recent 10-year period.

COLON AND RECTUM CANCER

Incidence: An estimated 138,000 new cases in 1985, including 96,000 of colon cancer and 42,000 of rectum cancer. Their combined incidence is second only to that of lung cancer (excluding common skin cancers).

Mortality: An estimated 59,900 deaths in 1985, second only to lung cancer. This includes 51,600 for colon cancer and 8,300 for rectum cancer.

Warning Signals: Bleeding from the rectum, blood in the stool, change in bowel habits.

Risk Factors: Personal or family history of colon and rectum cancer; personal or family history of polyps in the colon or rectum; inflammatory bowel disease.

Evidence suggests that bowel cancer may be linked to the diet. A diet high in fat and/or deficient in fiber content may be a significant causative factor.

Early Detection: The ACS recommends three tests as valuable aids in detecting colon and rectum cancer early in people without symptoms.

The digital rectal examination is performed by a physician during an office visit. The ACS recommends one every year after age 40.

The stool blood slide test is a simple method of testing the feces for hidden blood. The specimen is obtained by the patient at home, and returned to the physician's office, a hospital or clinic for examination. The ACS recommends the test every year after 50.

Proctosigmoidoscopy, known as the "procto," is an examination in which a physician inspects the rectum and lower colon with a hollow lighted tube, traditionally 25 cm long. As the site of most colorectal cancers appears to be shifting higher in the colon, longer, flexible instruments are being used. Now available is a 35 cm sigmoidoscope, thought to be useful in doctors' offices. The ACS recommends a procto every 3 to 5 years after the age of 50, following two annual exams with negative results.

If any of these tests reveals possible problems, a physician may recommend more extensive studies, such as colonoscopy and a barium enema. The longest available colonoscope is capable of viewing the entire colon with a flexible, lighted tube.

A national ACS study on colon and rectum cancer attitudes by the public[*] found that Americans over age 40 tend to pay these organs scant attention and have them checked infrequently by their physicians. Most study participants incorrectly thought the disease usually is found in an advanced stage when survival chances are slim. Many also erroneously regarded a permanent colostomy as a normal result of colon and rectum cancer. On the other hand, participants were receptive to accurate information about the disease, and expressed a willingness to practice early detection procedures.

Treatment: Surgery, at times combined with radiation, is the most effective method of treating colorectal cancer. Chemotherapy is being studied to determine its possible role in treating advanced cases.

In cases of colon cancer, permanent colostomies, the creation of an abdominal opening for the elimination of body wastes, are seldom needed, and infrequently required for patients with rectal cancer. One report found permanent colostomies necessary for only 15% of patients whose rectal cancers are detected early. For those who do have permanent colostomies, the Society has a special patient assistance program.

Survival: When colorectal cancer is detected and treated in an early, localized stage, the 5-year survival rate is 87% for colon cancer and 78% for rectal cancer, compared with 47% and 38% respectively, after the cancer has spread to other parts of the body.

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[*] Leo J. Shapiro & Assoc., Inc., 1982

BREAST CANCER

Incidence: An estimated 119,000 new cases in the United States during 1985. About one out of 11 women will develop breast cancer at some time during their lives.

Mortality: An estimated 38,400 deaths in 1985. It is the foremost site of cancer deaths in women.

Warning Signals: Breast changes that persist such as a lump, thickening, swelling, dimpling, skin irritation, distortion, retraction or scaliness of the nipple, nipple discharge, pain or tenderness.

Risk Factors: Over age 50; personal or family history of breast cancer; never had children; first child after age 30.

Early Detection: The American Cancer Society recommends the monthly practice of breast self-examination (BSE) by women 20 years and older as a routine good health habit. Most breast lumps are not cancer, but only a physician can make a diagnosis.

The American Cancer Society and the National Cancer Institute, in their joint Breast Cancer Detection Demonstration program, found that mammography — a low-dose x-ray examination — could find cancers too small to be felt by the most experienced examiner.

Besides its effectiveness in screening women without symptoms, mammography is recognized as a valuable diagnostic technique for women who do have findings suggestive of breast cancer. Once a breast lump is found, mammography can help determine if there are other lesions in the same or opposite breast which are too small to be felt. All suspicious lumps should be biopsied for a definitive diagnosis — even when the mammogram is described as normal.

The Society recommends a mammogram every year for asymptomatic women age 50 and over, and a baseline mammogram for those 35 to 39. Asymptomatic women 40 to 49 should have mammography every 1-2 years, depending on physical and mammographic findings as well as other risk factors. In addition, a professional breast examination is recommended every three years for women 20 to 40, and every year for those over 40.

Treatment: Several methods may be used, depending on the individual woman's preferences and medical situation — surgery varying from local removal of the tumor to mastectomy, radiation therapy, chemotherapy or hormone manipulation. Often two or more methods may be used in combination. Patients should discuss with their physicians possible options available concerning the specific management of their breast cancer.

New techniques in recent years have made breast reconstruction possible after mastectomy, and the cosmetic results are good. Reconstruction now has become an important part of treatment and rehabilitation.

Survival: The 5-year survival rate for localized breast cancer has risen from 78% in the 1940's to 96% today. If the breast cancer is not invasive (in situ), the survival rate approaches 100 percent. If the cancer has spread, however, the rate is 70%.

Despite an increasing incidence of breast cancer, longer survival has helped to stabilize mortality rates over the last 50 years.

SKIN CANCER

Incidence: Over 400,000 cases a year, the vast majority of which are highly curable basal or squamous cell cancers. They are more common among individuals with lightly pigmented skin, living at latitudes near the equator. The most serious skin cancer is malignant melanoma, which strikes about 22,000 men and women each year.

Mortality: An estimated 7,400 deaths a year, 5,500 from malignant melanoma, and 1,900 due to other skin cancers.

Warning Signals: Any unusual skin condition, especially a change in the size or color of a mole or other darkly pigmented growth or spot.

Risk Factors: Excessive exposure to the sun, fair complexion; occupational exposure to coal tar, pitch, creosote, arsenic compounds and radium. Among blacks, because of heavy skin pigmentation, skin cancer is negligible.

Prevention: Avoid the sun between 10:00 a.m. and 3 p.m. when ultraviolet rays are strongest, and by using protective clothing. Use one of the growing number of sunscreen preparations, especially those containing such ingredients as PABA (para-aminobenzoic acid). They come in varying strengths, ranging from those that permit gradual tanning to those allowing practically no tanning at all.

Early Detection: Recognition of changes in scales or the appearance of new skin growths is the best way to find early skin cancer. Basal and squamous cell skin cancers often take the form of a pale, waxlike, pearly nodule, or a red, scaly, sharply outlined patch.

Melanomas are usually distinguished by a dark brown or black pigmentation. They start as small, mole-like growths that increase in size, change color, become ulcerated and bleed easily from a slight injury.

Treatment: There are four methods of treatment — surgery, radiation therapy, electrodesiccation (tissue destruction by heat), or cryosurgery (tissue destruction by freezing).

For malignant melanoma, adequate surgical excision of the primary growth is indicated. Nearby lymph nodes may be removed. The microscopic examination of all suspicious moles is essential.

Survival: For basal cell and squamous cell cancers, cure is virtually assured with early detection and treatment. Malignant melanoma, however, can spread to other parts of the body quickly. The 5-year survival rate for white patients with malignant melanoma is 82% compared with 95% for patients with other kinds of skin cancer.

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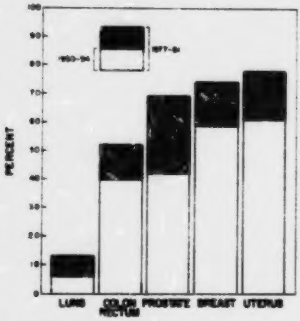
FIVE YEAR CANCER SURVIVAL RATES* TRENDS FOR SELECTED SITES— 1950-54 to 1977-81



*[illegible]
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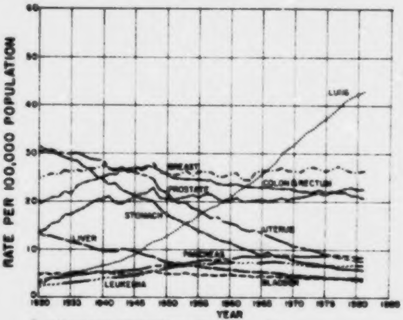
CANCER DEATH RATES* BY SITE UNITED STATES, 1930-81



* [illegible] 1970 U.S. population
Sources of Data National Center for Health Statistics and
Bureau of the Census, United States
Note: [illegible]

UTERINE CANCER

Incidence: An estimated 52,000 new invasive cases in 1985, including 15,000 cases of cancer of the cervix, and 37,000 cases of cancer of the endometrium or body of the uterus. Invasive cervical cancer incidence has steadily decreased over the years, while cancer in situ has risen in all groups. Cervical cancer is most common today among low socioeconomic groups but all groups are at risk. Endometrial cancer afflicts mostly mature women, and diagnosis usually is made between the ages of 50 and 64.

Mortality: An estimated 6,800 deaths in 1985 from cervical cancer, 2,900 from endometrial cancer. Overall, the death rate from uterine cancer has decreased more than 70% during the last 40 years, due mainly to the Pap test and regular checkups.

Warning Signals: Intermenstrual or postmenopausal bleeding or unusual discharge.

Risk Factors: For cervical cancer, early age at first intercourse, multiple sex partners. For endometrial cancer: history of infertility, failure of ovulation, prolonged estrogen therapy and obesity.

Early Detection: The Pap test, an examination under a microscope of cells from the cervix and body of the uterus, is a simple procedure which can be performed at appropriate intervals by physicians as part of every pelvic examination. For the average risk person, a Pap test is recommended once every three years after two initial negative tests one year apart.

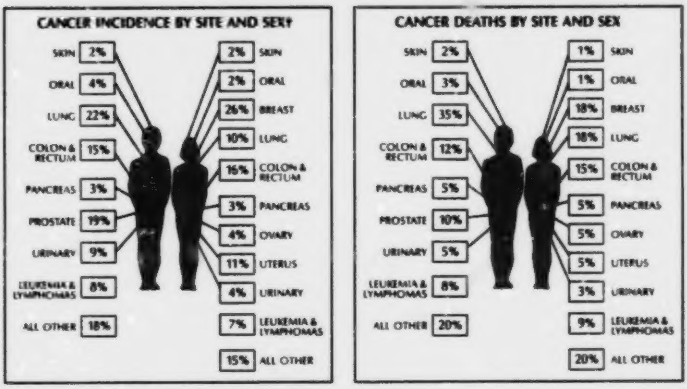
The Pap test is highly effective in detecting early cancer of the uterine cervix; it is only 50% effective in detecting endometrial cancer. Women at high risk of developing endometrial cancer should have an endometrial tissue sample at menopause.

The hormone estrogen frequently is given to women during and after menopause to make up for the decline in estrogens normally produced by the ovaries. Estrogen helps to control menopausal symptoms such as hot flashes or thinning of the vaginal lining causing painful sexual intercourse. For older women, there are certain risks associated with such treatment, including an increased risk of endometrial cancer. However, estrogen can be given safely under careful physician control.

Treatment: Uterine cancers generally are treated by surgery or radiation, or by a combination of the two. In precancerous (in situ) stages, changes in the cervix may be treated by cryotherapy (the destruction of cells by extreme cold), by electrocoagulation (the destruction of tissue through intense heat by electric current) or by local surgery. Precancerous endometrial changes may be treated with the hormone progesterone.

Survival: The 5-year survival rate for cervical cancer patients, whites and blacks, is 65%. For patients diagnosed early, however, the rate is 80-90%. Cancer in situ is virtually 100%. The figures for endometrial cancer are 84% all stages, 91% early and virtually 100% for endometrial precancerous lesions. During a recent 10-year period, there was moderate improvement for both uterine sites.

CANCER INCIDENCE AND DEATHS BY SITE AND SEX — 1985 ESTIMATES



†Excluding non-melanoma skin cancer and carcinoma in situ.

LEUKEMIA

Incidence: An estimated 25,000 new cases in 1985, about half of them acute leukemia, and half of them chronic leukemia. Although it is often thought of as primarily a childhood disease, leukemia strikes many more adults (22,500 cases per year compared with 2,500 in children). Acute lymphocytic leukemia accounts for about 1,800 of the cases of leukemia among children, whereas in adults the most common types are acute granulocytic (about 6,800 cases annually), and chronic lymphocytic (7,600 cases annually).

Mortality: An estimated 17,000 deaths in 1985.

Warning Signals: Symptoms of acute leukemia in children can appear suddenly. Early signs may include fatigue, paleness, weight loss, repeated infections, easy bruising, nose bleeds or other hemorrhages. Chronic leukemia can progress slowly and with few symptoms.

Risk Factors: Leukemia, a cancer of the bloodforming tissues, strikes both sexes and all ages. Causes of most cases are unknown. Individuals with Down's syndrome (mongolism) and certain other hereditary abnormalities have higher than normal incidence of leukemia. It has also been linked to excessive exposure to radiation and certain chemicals such as benzene.

Early Detection: Leukemia may be difficult to diagnose early because symptoms often appear to be those of other less serious conditions. When a physician does suspect leukemia, a diagnosis can be made through blood tests and an examination of bone marrow.

Treatment: Chemotherapy is the most effective method of treating leukemia. Today, continuing research in 80 U.S. medical centers is yielding new and better drugs for treating leukemia patients. A variety of anticancer drugs are used, usually in combinations or as single agents. To prevent persistence of hidden cells, therapy of the central nervous system has become standard treatment, especially in acute lymphocytic leukemia. Under appropriate conditions, bone marrow transplantation may be useful in the treatment of certain leukemias.

When leukemia occurs, millions of abnormal, immature white blood cells are released into the circulatory systems. These abnormal cells crowd out normal white cells to fight infection, platelets to control hemorrhaging and red blood cells to prevent anemia. Transfusions of blood components and antibiotics are used as supportive treatments.

Survival: The overall, average 5-year survival rate for white patients with leukemia is 33%, due partly to very poor survival of patients with some types of leukemia such as acute granulocytic. The 5-year survival rate for black patients is 29%. Over a recent 10-year period, however, there was a dramatic improvement in survival of patients with acute lymphocytic leukemia: 4%-27% in white males, 3%-29% in white females. In white children, the improvement has been from 4% to 65%. Moreover, in some medical centers, optimum treatment has raised survival of children with acute lymphocytic leukemia up to 75%.

ORAL CANCER

Incidence: An estimated 29,000 new cases in 1985. Incidence is more than twice as high in males as in females, and is most frequent in men over age 40. Cancer can affect any part of the oral cavity, from lip to tongue to mouth and throat.

Mortality: An estimated 9,500 deaths in 1985.

Warning Signals: A sore that bleeds easily and doesn't heal; a lump or thickening; a reddish or whitish patch that persists. Difficulty in chewing, swallowing or moving tongue or jaws are often late changes.

Risk Factors: Cigarette, cigar and pipe smoking; use of chewing tobacco; more than moderate drinking.

Early Detection: Dentists have the opportunity, through regular checkups, to see abnormal tissue changes and to detect cancer at an early and curable stage.

Treatment: Principal methods are radiation therapy and surgery. Chemotherapy is being studied as an aid to surgery in advanced disease.

Survival: 5-year survival rates vary substantially depending on the site, and include slight declines as well as improvements over a recent 10-year period. Rates range from 22% for cancer of the pharynx to 84% for lip cancer. Overall, 5-year survival for oral cancer patients is about 40%.

CANCER BY AGE AND RACE

CANCER RATES IN BLACKS AND WHITES*

A study of cancer rates over several decades shows that the cancer incidence rate for blacks is higher than for whites, and that blacks also have a higher death rate than whites.

Male incidence and mortality rates in each race increased, while female rates decreased.

The overall cancer incidence rate for blacks went up 27%, while for whites it increased 12%. Cancer mortality has increased in both races, but the rate for blacks is greater than for whites. In the last 30 years, cancer death rates in whites have increased 10%, while black rates have increased 40%. The rates were virtually the same 30 years ago.

Cancer sites where blacks had significantly higher increases in incidence and mortality rates included the lung, colon-rectum, prostate and esophagus. Esophageal cancer, long considered mainly a disease of males, declined in whites and rose rapidly in blacks of both sexes.

The incidence of invasive cancer of the uterine cervix dropped in both black and white women, although the incidence in blacks is still more than double that in whites. However, the rate for endometrial cancer — or cancer of the body of the uterus — for white women is double that of black women.

Survival for patients diagnosed between 1967 and 1973 was compared. More whites than blacks had cancer diagnosed in an early, localized stage when the chances of cure are best: 37% versus 28% for males, and 42% versus 31% for women.

A recent ACS-sponsored survey by the black-owned New York firm of Evaxx, Inc. showed that urban black Americans tend to be much less knowledgeable than whites about cancer's warning signals, and less apt to see a doctor if they experience those symptoms. Specifically, the blacks interviewed knew little about three of the cancers that have seen a sharp increase in mortality: colorectal, prostate and esophageal. The survey also showed that blacks tend to underestimate both the prevalence of cancer and the chances of cure.

In both studies, most of the differences between whites and blacks were attributed to economic, environmental and social factors rather than to inherent biological characteristics. Because a higher percentage of blacks than whites are in the lower socio-economic group, risk of exposure to industrial carcinogens is increased. Also, limited educational opportunities may prevent early detection because the less educated are less likely to know the importance of symptoms which could lead to an early diagnosis.

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*Figures for cancer incidence are from the National Cancer Institute National Surveys, 1947, and the NCI SEER Program, 1973-1981; those for cancer mortality from the National Center for Health Statistics, 1949-51 to 1979-81.

CANCER IN CHILDREN

Incidence: An estimated 6,000 new cases in 1985, making it rare as a childhood disease. Common childhood cancer sites include the blood (bone marrow), bone, brain, nervous system, kidneys and soft tissues.

Mortality: An estimated 1,600 deaths in 1985, about half of them from leukemia. Despite its rarity, cancer is still the chief cause of death by disease in children between the ages of 3 and 14. Mortality among children with cancer has declined from 8.3 per 100,000 in 1950 to 4.2 in 1981.

Early Detection: Cancers in children often are difficult to recognize since they may seem like trivial disorders at first. Parents should see that their children have regular medical checkups, and be alert to any unusual symptoms that persist. Such conditions include unusual lumps, double vision, nosebleeds, drowsiness, listlessness and failure to thrive.

Main Childhood Cancers

Leukemia: See preceding section.

Osteogenic Sarcoma and *Ewing's Sarcoma* are bone cancers. There may be no pain at first, but swelling in the area of the tumor is often a first sign.

Neuroblastoma, or *Cancers of the Nervous System*, can appear anywhere but usually in the abdomen, where a swelling occurs.

Rhabdomyosarcoma, the most common soft tissue sarcoma, can occur in the head and neck area, genito-urinary area, trunk and extremities.

Brain Cancers in early stages may cause headaches, blurred or double vision, dizziness, difficulty in walking or handling objects, and nausea.

Lymphomas, or *Hodgkin's Disease* are cancers that involve the lymph nodes, bone marrow and various organs throughout the body. They may cause swelling of lymph nodes in the neck, armpit or groin. Other symptoms may include general weakness and possibly fever.

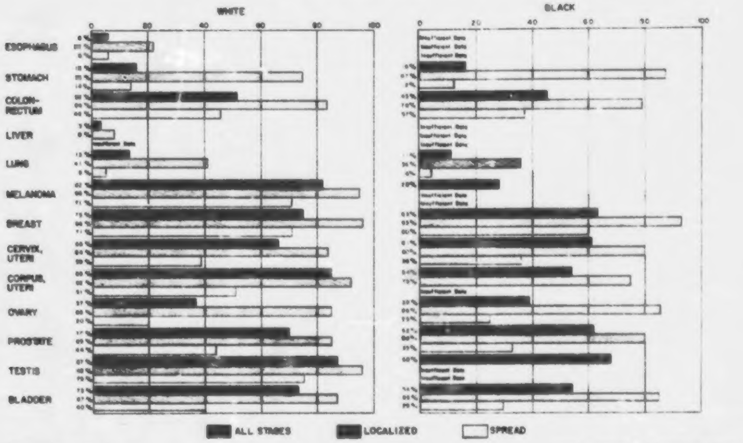
Eye Cancers, or *Retinoblastoma* usually occur in children under the age of four. When detected early, cure is possible with appropriate treatment.

Cancer of the Kidney, or *Wilms' Tumor* may be recognized by a swelling or lump in the abdomen.

Treatment: Childhood cancers are frequently treated by a combination of therapies, coordinated by a team of experts. They include medical specialists, pediatric nurses, social workers and psychologists who work with children and their families.

Survival: 5-year survival rates for cancer in children vary considerably, depending on the site. Among those for white children (black information is insufficient) are: bone cancer, 45%; neuroblastoma, 51%; brain and central nervous system, 53%; Wilms' tumor (kidney), 78%, and Hodgkin's disease, 88%.

FIVE YEAR CANCER SURVIVAL RATES* FOR SELECTED SITES BY RACE



*Adjusted for normal life expectancy

This chart is based on cases diagnosed in 1977-[illegible]

Source: Biometry Branch, National Cancer Institute

TRENDS IN SURVIVAL BY SITE OF CANCER, BY RACE
Cases Diagnosed in 1960-63, 1970-73, 1973-75, 1976-81

	WHITE				BLACK			
	RELATIVE 5-YEAR SURVIVAL				RELATIVE 5-YEAR SURVIVAL			
SITE	1960-63[1]	1970-73[1]	1973-75[2]	1976-81[2]	1960-63[1]	1970-73[1]	1973-75[2]	1976-81[2]
Esophagus	4	4	5	6	1	4	2	4
Stomach	11	13	14	15	8	13	14	16
Colon	43	49	49	53	34	37	44	47
Rectum	38	45	47	49	27	30	35	39
Lung and Bronchus	8	10	12	13	5	7	10	11
Melanoma of Skin	60	68	76	80	*	*	*	*
Breast	63	68	74	75	46	51	63	63
Uterine Cervix	58	64	68	67	47	61	62	63
Uterine Corpus	73	81	89	86	31	44	59	55
Ovary	32	36	36	37	32	32	37	40
Prostate	50	63	65	71	35	55	56	61
Testis	63	72	76	87	*	*	67	70
Bladder	53	61	73	74	24	36	44	54
Kidney	37	46	50	50	38	44	47	52
Brain	18	20	20	22	19	19	20	25
Hodgkin's Disease	40	67	67	74	*	*	68	70
Non-Hodgkin's Lymphoma	31	41	45	48	*	*	46	48
Leukemia	14	22	33	33	*	*	27	29

Source: Biometry Branch, National Cancer Institute

[1] Rates are based on data from a series of hospital registries and one population-based registry.

[2] Rates are from the SEER Program and include patients diagnosed through 1981 and follow-up on all patients through 1982. They are based on data from population-based registries in Connecticut, New Mexico, Utah, Iowa, Hawaii, Atlanta, Detroit, Seattle-Puget Sound, and San Francisco-Oakland.

*Rates could not be calculated because of insufficient number of cases.

ESTIMATED NEW CASES AND DEATHS FOR MAJOR SITES OF CANCER — 1985*

SITE	NO. OF CASES	DEATHS
Lung	144,000	126,000
Colon-Rectum	138,000	60,000
Breast (Female)	119,000	38,000
Prostate	86,000	26,000
Urinary	60,000	20,000
Uterus	52,000**	10,000
Oral	29,000	10,000
Pancreas	25,000	24,000
Leukemia	25,000	17,000
Skin	22,000***	7,000
Ovary	19,000	12,000

*Figures rounded to nearest 1,000.
**If carcinoma in situ is included, cases total over 100,000.
***Estimated new cases of non-melanoma over 400,000.
INCIDENCE ESTIMATES ARE BASED ON RATES FROM N.C.I. SEER PROGRAM 1977-1981

TRENDS IN AGE-ADJUSTED CANCER DEATH RATES* PER 100,000 POPULATION BY STATES FOR THE LAST THREE DECADES

	ALL SITES		
STATE	**1950-59**	**1960-69**	**1970-79**
Alabama	133.0	144.6	161.4
Alaska	—	147.2	161.5
Arizona	130.8	143.3	145.1
Arkansas	123.7	140.4	155.4
California	154.5	159.2	166.2
Colorado	141.8	136.6	137.1
Connecticut	180.5	175.5	177.8
Delaware	164.9	176.2	189.8
Dist. of Columbia	205.0	213.5	233.5
Florida	136.2	150.7	163.6
Georgia	134.9	145.9	160.0
Hawaii	—	150.4	143.0
Idaho	129.5	132.5	137.7
Illinois	172.1	173.3	177.6
Indiana	154.9	161.5	170.6
Iowa	149.0	150.6	158.8
Kansas	135.2	142.3	153.4
Kentucky	138.2	150.3	169.1
Louisiana	161.4	170.2	180.3
Maine	168.1	170.6	176.7
Maryland	173.1	181.3	193.9
Massachusetts	178.8	172.3	179.4
Michigan	169.6	170.9	174.0
Minnesota	152.7	151.9	152.7
Mississippi	133.8	140.3	158.4
Missouri	154.8	159.5	168.3
Montana	143.3	146.2	151.5
Nebraska	152.2	151.0	154.9
Nevada	141.7	155.6	163.4
New Hampshire	173.4	175.3	179.4
New Jersey	189.6	185.8	187.7
New Mexico	124.9	132.8	142.9
New York	186.1	183.0	182.7
North Carolina	124.0	138.7	157.7
North Dakota	139.4	142.7	143.0
Ohio	166.3	171.8	178.3
Oklahoma	140.3	146.8	155.2
Oregon	143.0	146.9	155.2
Pennsylvania	172.2	173.9	176.9
Rhode Island	183.2	184.3	189.4
South Carolina	132.7	144.7	161.4
South Dakota	145.4	145.7	146.8
Tennessee	135.9	145.7	161.3
Texas	137.8	148.7	150.4
Utah	125.0	125.0	122.0
Vermont	161.9	165.6	170.7
Virginia	142.8	156.3	171.2
Washington	152.5	153.3	160.6
West Virginia	140.7	153.8	166.0
Wisconsin	161.8	156.4	159.5
Wyoming	134.0	131.2	141.9
United States	158.3	162.4	169.0

*Rate for the population standardized for age on the 1970 U.S. population.

PREVENTION

PRIMARY PREVENTION

SMOKING	Cigarette smoking is responsible for 85% of lung cancer cases among men and 75% among women — about 83% overall. If the number of smokers was reduced by half, 75,000 lives would be saved each year. Smoking accounts for about 30% of all cancer deaths.
NUTRITION	Risk for colon, breast and uterine cancers increases for obese people. High-fat diet may be a factor in the development of certain cancers such as breast, colon and prostate. High-fiber foods may help reduce risk of colon cancer. Foods rich in vitamins A and C may help lower risk for cancers of larynx, esophagus and lung. Eating cruciferous vegetables may help protect against certain cancers. Salt-cured, smoked and nitrite-cured foods have been linked to esophageal and stomach cancer. The heavy use of alcohol, especially when accompanied by cigarette smoking or chewing tobacco, increases risk of cancers of the mouth, larynx, throat, esophagus, and liver. (See below)
SUNLIGHT	Almost all of the 400,000 cases of non-melanoma skin cancer developed each year in the U.S. are considered to be sun-related. Recent epidemiological evidence shows that sun exposure is a major factor in the development of melanoma and that the incidence increases for those living near the equator. (See Major Cancer Sites: Skin Cancer)
ALCOHOL	Oral cancer and cancers of the larynx, throat, esophagus and liver occur more frequently among heavy drinkers of alcohol. (See Major Cancer Sites: Oral Cancer)
SMOKELESS TOBACCOS	Increased risk factor for cancers of the mouth, larynx, throat, and esophagus. Highly habit forming. (See Major Cancer Sites: Lung Cancer and Oral Cancer)
ESTROGEN	For mature women, certain risks associated with estrogen treatment to control menopausal symptoms, including an increased risk of endometrial cancer. However, estrogen can be given safely under careful physician control. (See Major Cancer Sites: Uterine Cancer)
RADIATION	Excess exposure to X ray can increase cancer risk. Most medical X rays are adjusted to deliver the lowest dose possible without sacrificing image quality.
OCCUPATIONAL HAZARDS	Exposure to a number of industrial agents (nickel, chromate, asbestos, vinyl chloride, etc.) increases risk. Risk factor greatly increased when combined with smoking.

SECONDARY PREVENTION

COLORECTAL TESTS	The ACS recommends three tests for the early detection of colon and rectum cancer in people without symptoms. The digital rectal examination, performed by a physician during an office visit, should be performed every year after the age of 40; the stool blood test is recommended every year after 50; and the proctosigmoidoscopy examination should be carried out every 3 to 5 years after the age of 50 following two annual exams with negative results. (See Major Cancer Sites: Colon and Rectum Cancer)
PAP TEST	For the average risk person, a Pap test is recommended annually until two consecutive satisfactory tests are negative, and then once every three years. The Pap test is highly effective in detecting cancer of the uterine cervix, but is less effective in detecting endometrial cancer.
BREAST CANCER DETECTION	The ACS recommends the monthly practice of breast self-examination (BSE) by women 20 years and older as a routine good health habit. Physical examination of the breast should be done every three years from ages 20-40 and then every year. The ACS recommends a mammogram every year for asymptomatic women age 50 and over, and a baseline mammogram between ages 35 and 39. Women 40 to 49 should have mammography every 1-2 years, depending on physical and mammographic findings.

COLORECTAL CANCER: EARLY DETECTION IS THE KEY

When cancer of the colon and rectum is found and treated in an early, localized stage, the 5-year survival rate is 87% for colon cancer and 78% for rectal cancer. However, survival figures drop to 47% and 38%, respectively, after the cancer has spread to other parts of the body.

Because colorectal cancer develops over a period of time, detection of the disease is possible long before symptoms appear. Early detection of small cancers and polyps reduces the likelihood of major surgery and the need for a colostomy — an abdominal opening created for the elimination of wastes. In fact, permanent colostomies are rare in cases of colon cancer, and are necessary in only 15% of rectal cancer cases.

Colorectal cancer is second only to lung cancer in terms of incidence. Currently, about 138,000 new cases develop each year; more than 59,900 people die from the disease annually. The incidence of colorectal cancer tends to increase with age, starting at 40 years. More than 94% of all cases occur after the age of 50. Colorectal cancer occurs about equally in both sexes. Anyone with a personal or family history of colorectal cancer, polyps in the colon or inflammatory bowel disease, is at particularly high risk for the disease and should be examined carefully.

Projected 5-year survival rates for colorectal cancer show that early detection saves lives. Currently, the 5-year survival rate is estimated at 45%. With the use of early detection techniques, such as the digital rectal exam, the stool blood test and sigmoidoscopy, the survival rate for patients with colorectal cancer could be increased from 45% to 75%. This means that, over a period of time, 100,000 lives, versus the current 60,000, could be saved each year.

It is recommended that the following procedures, all part of a cancer-related checkup, be performed at designated intervals:

- A digital rectal examination every year after age 40.
- A stool blood test every year after age 50.
- A procto every three to five years after the age of 50, following two annual examinations with negative results.

These guidelines apply only to people without symptoms. Persons with rectal bleeding, gnawing, cramping abdominal pain, or a change in bowel habits should see their doctor immediately.

Evidence suggests that bowel cancer may be linked to the diet. A diet high in fat and/or deficient in fiber content may be a significant causative factor.

NUTRITION AND CANCER: A COMMON SENSE APPROACH

Extensive research is under way to evaluate and clarify the role diet and nutrition play in the development of cancer. At this point, no direct cause-and-effect relationship has been proved, though statistics show that some foods may increase or decrease the risks for certain types of cancer. Evidence indicates that people might reduce their cancer risk by observing the following recommendations:

1. Avoid obesity.

Individuals 40% or more overweight increase their risk of colon, breast, prostate, gallbladder, ovary, and uterine cancers. People with weight problems should consult their physician to determine their best body weight, since their medical condition and body build must be taken into account. Physicians can recommend a suitable diet and exercise regime to help maintain an appropriate weight.

2. Cut down on total fat intake.

A diet high in fat may be a factor in the development of certain cancers, particularly breast, colon and prostate. In addition, by avoiding fatty foods, people are better able to control body weight.

3. Eat more high fiber foods such as whole grain cereals, fruits and vegetables.

Regular consumption of cereals, fresh fruits and vegetables is recommended. Studies suggest that diets high in fiber may help to reduce the risk of colon cancer. Furthermore, foods high in fiber content are a wholesome substitute for foods high in fat.

4. Include foods rich in vitamins A and C in your daily diet.

People should include in their diet dark green and deep yellow fresh vegetables and fruits, such as carrots, spinach, yams, peaches, and apricots as sources of vitamin A, and oranges, grapefruit, strawberries, green and red peppers for vitamin C. These foods may help lower risk for cancers of the larynx, esophagus and the lung. The excess use of vitamin A supplements is not recommended because of possible toxicity.

5. Include cruciferous vegetables in your diet.

Certain vegetables in the cruciferous family — cabbage, broccoli, Brussels sprouts, kohlrabi and cauliflower — may help prevent certain cancers from developing. Research is in progress to determine how these foods may protect against cancer. Cruciferous vegetables have flowers with four leaves in the pattern of a cross.

6. Eat moderately of salt-cured, smoked and nitrite-cured foods.

In areas of the world where salt-cured and smoked foods are eaten frequently, there is more incidence of cancer of the esophagus and stomach. The American food industry has developed new processes to avoid possible cancer-causing by-products.

7. Keep alcohol consumption moderate, if you do drink.

The heavy use of alcohol, especially when accompanied by cigarette smoking or smokeless tobacco, increases risk of cancers of the mouth, larynx, throat, esophagus and liver.

SMOKING

The American Cancer Society estimates that cigarette smoking is responsible for 85% of lung cancer cases among men and 75% among women — about 83% overall.

The cancer death rate for male cigarette smokers is more than double that of nonsmokers, and the rate for female smokers is 67% higher than for nonsmokers.

The higher cancer rates for men reflect the fact that in the past, more men than women smoked, and smoked more heavily. In recent years, however, the gap between male and female smoking has been narrowing.

Smoking also has been implicated in cancers of the mouth, pharynx, larynx, esophagus, pancreas and bladder. Smoking accounts for about 30% of all cancer deaths, is a major cause of heart disease, and is linked to conditions ranging from colds and gastric ulcers to chronic bronchitis and emphysema.

Smoking is related to 320,000 deaths each year and costs the nation more than $27 billion in medical care.

A Decline in Smoking

A June 1984 tobacco report of the U.S. Department of Agriculture estimates cigarette output in 1983-84 at 661 billion, down about 2.5% from last year. Consumption during the same period dropped about 3.5%.

From 1976 to 1983, adult male smokers (20 years and older) dropped from 41.9% of the population to 35.2%, while women smokers decreased from 32.0% to 29.1%, according to the National Center for Health Statistics. Overall, the percentage of men and women smokers in the population had dropped to 32.0%. Other recent polls indicate that the proportion of smokers may have dropped to 30%.

Per capita cigarette consumption among adults has fallen — from 4,141 in 1974 to 3,411 in 1984 — reflecting a growing number of ex-smokers. This is the lowest per capita consumption since 1944. From 1965 to 1983, the proportion of adult male ex-smokers (20 years and older) in the total U.S. population increased from 20.5% to 30.3%, while female ex-smokers rose from 8.2% to 15.9%.

A survey supported by the National Institute on Drug Abuse indicated that the percentage of high school seniors (aged 17 and 18) who smoked cigarettes daily decreased by about a quarter, from 28.8% in 1976 to 21.2% in 1983.

It is now estimated — from past national surveys and data from the Cancer Prevention Study II — that there are more than 35 million ex-cigarette smokers in the United States today.

At the same time, however, the average smoker appears to be smoking more heavily. The U.S. Office on Smoking and Health reports that the proportion of adult male smokers (20 years and older) consuming 25 or more cigarettes per day increased from 31.0% to 34.1% between 1976 and 1980, and female smokers from 19.6% to 23.7%.

Figures from the U.S. Department of Agriculture show that a total of 600 billion cigarettes were consumed in 1983, a drop of 5.4% in one year. The Federal excise tax on cigarettes was raised by 8 cents a pack in January 1983. Preliminary figures for 1984 indicate there may be another 1% drop in cigarette consumption in 1984.

Ways of Quitting

A Federal Trade Commission staff report states that although most Americans are aware of a health risk in smoking, more than 40% don't know smoking causes most lung cancer, and 20% don't know it can cause cancer at all. More than 30% are unaware that smoking doubles a person's risk of heart attack, and 50% of women do not know that smoking during pregnancy increases the risk of stillbirth and miscarriage.

The report prompted the Society to launch an accelerated educational effort to help smokers understand how dangerous smoking is and how specific smoking-related health risks apply to them personally.

Comprehensive Approach

The Society recommends a comprehensive approach to smoking control at the local level:

1. encouraging young people not to start smoking,
2. educating the public in the hazards of smoking with the aim of getting smokers to quit on their own,
3. providing self-help materials and working with the media,
4. recruiting ex-smoker volunteers to provide one-to-one help for smokers now trying to quit,
5. first encouraging and preparing industries, hospitals and organizations to conduct smoking cessation programs on their own, and then making available FRESHSTART, the new, cost-effective ACS quit-smoking group program, and,
6. supporting legislation to restrict smoking in public places.

Lower Tar & Nicotine

Research has shown that there is no such thing as a "safe" cigarette, but that those who are not yet able to quit would be well advised to switch to brands with the lowest possible tar and nicotine (T/N) content. Moreover, low T/N smokers find it easier to quit altogether than high T/N smokers.

In an ACS study conducted from 1960 to 1972, the average mortality of low T/N smokers was 16% lower than that of high T/N smokers, and the comparable figure for lung cancer mortality was 26%.

It is important to remember that besides tar and nicotine, cigarette smoke contains a host of other poisonous gases such as hydrogen cyanide, volatile aromatic hydrocarbons, and especially carbon monoxide — possibly a critical factor in coronary heart disease and fetal growth retardation, among other things. While some hazards are reduced slightly by cigarette filters, certain filtered brands have been found to actually deliver more carbon monoxide than those without filters.

Passive Smoking Hazards

There may even be hazards for non-smokers who breathe the smoke of others' cigarettes. Two scientific studies recently indicated an increased risk of lung cancer among the nonsmoking wives of cigarette smokers. Another study, however, found little if any risk for these "passive smokers."

The question has not been resolved, and there is cause for concern. Therefore, the American Cancer Society believes that further research is urgently needed. The Society's Cancer Prevention Study II, involving more than one million Americans, includes a careful assessment of cancer risk and other diseases among smokers and passive smokers.

Industrial Hazards

Industrial workers are especially susceptible to lung diseases due to the combined effects of cigarette smoking and exposure to toxic industrial substances such as fumes from rubber, chlorine and dust from cotton and coal. Exposure to asbestos in combination with cigarette smoking increases an individual's cancer risk nearly 60 times.

In his 1982 report, *The Health Consequences of Smoking*, U.S. Surgeon General C. Everett Koop confirmed many of the ACS findings, declaring that cigarette smoking is "the chief, single, avoidable cause of death in our society, and the most important health issue of our time."

CANCER CONTROL

PUBLIC EDUCATION

Because each year thousands of lives could be saved through cancer prevention and early detection, the Society's Public Education programs are designed to inform people about cancer, tell what they can do to protect themselves, and demonstrate related health practices.

The Society believes strongly in the value of periodic, cancer-related checkups and specific cancer tests, as well as prompt action in the event that one of cancer's seven warning signals occurs.

Six cancer sites offer the greatest opportunity for prevention or cure: lung, colorectal, breast, uterine, oral and skin. Cancers at these sites account for the majority of cancer cases and about half of all cancer deaths.

P-A-C-E Strategy

The Society's P-A-C-E (Priority Activities in Cancer Education) planning strategy focuses on the first four of these six sites — where prevention or early detection provides the biggest payoff in lives saved.

ACS Public Education programs are divided into two major audience categories: adults and youth. Adults are reached through the workplace, clubs and organizations, home and neighborhood, and through programs with other health agencies. Youth programs are organized according to school grade: kindergarten through 6th; 7th through 9th; and 10th through 12th. These programs teach young people good health habits, help them make healthful lifestyle decisions and understand health behavior as it relates to cancer.

Programs for adults are carried out in small group settings or on a one-to-one basis, involving two-way communication and interaction. Whenever possible, volunteers are selected on the basis of skills that can be readily adapted to Society work, such as ex-smokers with group experience who help in smoking cessation programs, and nurses who can teach breast self-examination to groups of women. The Society reinforces its Public Education messages with a variety of films, filmstrips, pamphlets and posters.

Reaching More People

This year, local ACS Public Education programs involving two-way communication are expected to have reached 15 million adults and over 30 million young people.

For the rest of the decade, the Society has set specific behavioral goals of persuading more Americans to have tests for colorectal cancer, reducing the number of smokers, and increasing the number of women who practice monthly breast self-examination, get Pap tests and have endometrial tissue samples taken.

In 1985, the Society is expanding a three-year special project — Colorectal Health Check — to reach more Americans with Public Education programs on colon and rectum cancer.

In addition to the Society's intensive, person-to-person educational outreach, broader ACS programs blanket the nation with lifesaving messages. During the annual Cancer Crusade, volunteers make personal home visits, urging individuals to protect themselves against cancer.

More than 60 million educational leaflets are distributed each year, and important cancer educational messages reach nearly every U.S. household through television, radio and the print media.

Cancer-Related Checkup Guidelines

Guidelines for the early detection of cancer in people without symptoms are recommended by the American Cancer Society as follows: A cancer-related checkup:

- every 3 years for those 20-40 years of age
- every year for those 40 and over

The Society advises: "Talk with your doctor — ask how the guidelines relate to you." The checkup should always include health counseling (such as tips on quitting smoking) and examinations for cancer of the thyroid, testes, prostate, mouth, ovaries, skin and lymph nodes.

In particular:

- Ages 20-40 — For breast cancer, an examination by a physician every three years, a self-exam every month, and one baseline breast X ray between the ages of 35 and 39. For uterine cancer, a pelvic exam every three years and a Pap test at least every three years after two initial negative tests one year apart (including women under 20 if sexually active.)
- Ages 40 and over — For breast cancer, an exam by a doctor every year, a self-exam every month and a breast X ray every 1-2 years for those 40-49; every year for those 50 and over. For uterine cancer, a pelvic exam every year, a Pap test at least every three years (after two negative tests a year apart), and an endometrial tissue sample at menopause, if at risk. For colon and rectum cancer, a digital rectal exam every year after 40, and a stool blood test every year after 50 as well as a procto exam every 3-5 years after two initial negative tests one year apart.

Some people are at higher risk for certain cancers and may need to have tests more frequently. See "Major Cancer Sites" for high risk factors.

PROFESSIONAL EDUCATION

ACS Professional Education programs bring the latest developments in cancer to the medical community: members and students of the medical, dental, nursing and allied health professions.

Professional Education's National conferences, clinical fellowships, materials, professorships and scholarships provide information and training in the prevention and early detection of cancer, and in the treatment and rehabilitation of cancer patients. Its involvement in such Division and Unit programs as the Colorectal Health Check and the Great American Smokeout, are part of the overall ACS Professional Education effort.

Audiovisuals, Journals

Videotapes, films, slide sets, audiotapes, publications and exhibits are also available for Professional Education programs in hospitals as well as in medical, dental and nursing schools, and are used by professional societies at local and national meetings.

The ACS publishes *Ca-A Cancer Journal for Clinicians*, which is directed particularly to the primary care physician and has a total circulation of more than 470,000. The Society supports the publication of *Cancer*, directed to those specializing in the care of the cancer patient.

The Society maintains a library of Professional Education motion pictures, videocassettes and slide sets. All are distributed through ACS Divisions and Units on a free loan, five-year lease or direct sale basis.

Nursing Programs

Cancer Nursing News, a newsletter sent to about 80,000 nurses, began publication in 1982. The newsletter keeps nurses up to date on cancer, oncology nursing, the American Cancer Society, and opportunities in continuing education. The newsletter is sent free to any nurse who desires it. Requests for subscriptions should be sent to the Executive Editor, *Cancer Nursing News*, c/o American Cancer Society, 4 West 35th St., New York, NY 10001.

In 1981 the Society initiated a program of nursing scholarships. Twenty one-year scholarships are awarded each year to qualified graduate students studying for a master's degree with a specialty in cancer nursing. The recipients may apply for a second year's funding.

Another recently launched program, "Clinical Professorships in Oncology Nursing," provides a means for ACS Divisions to support selected individuals who will develop high quality cancer teaching programs within schools of nursing.

Clinical Oncology Awards

Since 1948, the ACS National Clinical Fellowship program has spent more than $40 million to train some 7,400 physicians and dentists in the diagnosis and treatment of cancer. Training has been provided on two levels at centers and hospitals with qualified training programs.

The Regular Clinical Fellowship program — for hospital residents — is designed to improve the management of the patient with cancer by supporting clinical oncology training for young physicians and dentists.

The Junior Faculty Clinical Fellowship program — for postresident physicians and dentists — is intended to strengthen cancer teaching programs by supporting outstanding young clinicians in academic careers.

During 1984-85, training will be supported for 367 Regular Clinical Fellows and 150 Junior Faculty Clinical Fellows.

The Clinical Fellowship program has been extremely successful in achieving its goal of increasing the number of highly qualified oncologists providing cancer care. In the future, the emphasis of the program will be on developing *academic* oncologists who will acquire both clinical oncology expertise and the ability to perform independent clinical oncology research.

Beginning in 1985, the Society will award Clinical Oncology Career Development Awards to some outstanding individuals who have demonstrated a commitment to pursue an academic career in oncology.

Unproven Methods of Cancer Management

The American Cancer Society maintains information on unproven methods of cancer management. This information is reviewed in-depth and issued as position statements. These statements are available on request to physicians, science writers, editors and the general public, to assist in evaluating claims made for unproven methods of cancer prevention, detection, diagnosis and treatment.

The Society welcomes new developments which have been proven scientifically effective and safe in the prevention, detection, diagnosis or treatment of cancer.

SERVICE & REHABILITATION

In 1984, nearly one half million cancer patients have been reached through the innovative service and rehabilitation programs of the American Cancer Society. Because of the many volunteers at the Division and Unit levels, the Society is able to offer a wide range of services encompassing:

1. Information and guidance directing patients to Society services, community resources and specific information about cancer.
2. Home care items for use by patients.
3. Transportation of cancer patients, assisting them in getting to and from medical and therapy appointments.
4. Rehabilitation programs helping patients return to their families, communities and occupations through carefully trained and selected visitor and group programs.
5. Patient/family education programs to provide a better understanding of the disease and its management through group education programs, pamphlets, booklets and audiovisual presentations.

Information and Guidance services provide specific information about cancer as well as referral to Society services and other resources in the community to meet the social, psychological and home care needs of cancer patients and their families.

Rehabilitation Programs

Patient Visitor Program (CanSurmount) is a short-term visitor program for patients, and the families of patients, with all types of cancer. Hospital and home visits are made with the approval and awareness of the physician. The one-to-one visit by a person who has experienced the same type of cancer offers functional, emotional and social support.

Reach to Recovery is the largest of the Society's patient visitor programs. It addresses the many needs of women with breast cancer. Women volunteers, who have successfully adjusted to their treatment for breast cancer, are available to visit new patients with the approval of the attending physician. A visit from a Reach to Recovery volunteer demonstrates that a woman treated for breast cancer can return to an active, normal life. The program provides information, as appropriate, on prostheses, breast reconstruction and new options on breast cancer management. In addition, literature and services to help husbands, children and friends of breast cancer patients are available.

Laryngectomy Rehabilitation Program spearheaded by The International Association of Laryngectomees (IAL), brings the message that a laryngectomee can return to a normal life. Coordinated through more than 325 clubs, laryngectomee visitors, who themselves have had their larynxes (voice boxes) removed because of cancer, provide pre- and/or post-operative support to patients who have recently undergone the laryngectomy operation.

Ostomy Rehabilitation Program — Some patients with intestinal or urinary cancers must have abdominal ostomies (surgically constructed openings for elimination of wastes). Trained volunteers who have experienced this same type of surgery offer help on a one-to-one basis. Cooperating with the United Ostomy Association and enterostomal therapists, patients are assisted in their physical and psychological adjustment.

Patient and Family Education

The Society sponsors group and individual education programs, distributes pamphlets and booklets for an individual's use, and provides audiovisual presentations. Group programs such as *I CAN COPE* provide information on cancer therapy, treatment, side effects, nutrition, resource availability and other topics of interest to cancer patients and family. The Society is continuing its expansion of patient education services by providing a broader variety of pamphlets, books and audiovisual aids for adult and children patients and their families to help them understand, and deal with the complexities of the disease.

Other Programs

Home Care Items — A program providing necessary and useful home care items, supplies, equipment, dressings and gifts for the comfort and recreation of the patient.

Transportation — Through the efforts of volunteer drivers in programs such as Road to Recovery, cancer patients receive transportation for diagnosis, treatment, rehabilitation and continuing care.

COSTS OF CANCER

A study by the National Center for Health Statistics (NCHS) puts overall medical costs for cancer at $10.8 billion for 1980. Because medical care costs have been inflating at 20% or more a year, that figure could easily have doubled by now.

In the NCHS study, 67% of the total amount was spent for hospital care, 23% for physicians' services, 5% for drugs, 4% for nursing home care, and 1% for other professional services.

Individual costs vary considerably, depending on the location of the cancer, possible recurrences and the extent of follow-up care. Daily hospital fees alone can run $250 or more a day, and each course of therapy can amount to several thousand dollars.

A study by the Blue Cross and Blue Shield Association estimates that the average American who died of cancer in 1983 ran up more than $22,000 in medical bills during the final year of life. The study, based on cases in Michi-

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gan, Indiana and Georgia, was funded by the U.S. Health and Human Services Department.

Individuals have several sources of help in paying for cancer costs: third-party payers such as Blue Cross and private insurance companies, public agencies and private health organizations. Cancer is covered by personal insurance plans either under narrowly defined cancer policies or through catastrophic illness provisions in comprehensive insurance programs.

The Third National Cancer Survey showed that for patients under 65 years, Blue Cross and private insurers were the source of payment in over 77% of the cases. For patients over 65, Medicare paid expenses in nearly 88% of the cases.

Hospital costs can be reduced substantially through the use of nursing facilities, hospices for advanced cancer patients, and home care with periodic professional medical visits.

30-YEAR TRENDS IN AGE-ADJUSTED CANCER DEATH RATES PER 100,000 POPULATION
1949-51 to 1979-81

SEX	SITES	1949-51	1979-81	PERCENT CHANGES	COMMENTS
Male	All Sites	168.0	217.0	+ 29	Steady increase mainly due to lung cancer.
Female	All Sites	147.8	135.5	− 8	Slight decrease.
Male	Bladder	7.2	6.6	•	Slight fluctuations; overall no change.
Female	Bladder	3.2	1.9	− 41	Some fluctuations; noticeable decrease.
Male	Breast	0.4	0.2	•	Constant rate.
Female	Breast	25.9	26.3	+ 2	Slight fluctuations; overall no change.
Male	Colon & Rectum	26.2	25.4	•	Slight fluctuations; overall no change.
Female	Colon & Rectum	25.3	18.5	− 27	Slight fluctuations; noticeable decrease.
Male	Esophagus	4.7	5.5	+ 17	Some fluctuations; slight increase.
Female	Esophagus	1.2	1.5	•	Slight fluctuations; overall no change in female.
Male	Kidney	3.3	4.7	+ 42	Steady slight increase.
Female	Kidney	2.0	2.1	•	Slight fluctuations; overall no change.
Male	Leukemia	7.3	8.7	+ 19	Early increase, later leveling off and decrease.
Female	Leukemia	5.0	5.1	•	Slight early increase, later leveling off.
Male	Liver	6.9	4.8	− 30	Some fluctuations. Steady decrease in both sexes.
Female	Liver	8.0	3.5	− 56	
Male	Lung	22.0	71.2	+ 224	Steady increase in both sexes due to cigarette smoking.
Female	Lung	4.8	20.7	+ 331	
Male	Oral	6.4	5.6	•	Slight fluctuations; overall no change in both sexes.
Female	Oral	1.6	1.9	•	
Female	Ovary	7.9	8.0	+ 1	Steady increase, later leveling off and decrease.
Male	Pancreas	8.2	10.6	+ 29	Steady increase in both sexes, then leveling off. Reasons unknown.
Female	Pancreas	5.5	7.0	+ 27	
Male	Prostate	20.8	22.7	+ 9	Fluctuations throughout; overall slight increase.
Male	Skin	3.3	3.5	•	Slight fluctuations; overall no change in both sexes.
Female	Skin	2.1	1.8	•	
Male	Stomach	24.6	8.3	− 66	Steady decrease in both sexes; reasons unknown.
Female	Stomach	13.5	3.9	− 71	
Female	Uterus	21.6	7.8	− 64	Steady decrease.

*Percent changes not listed because they are not meaningful.

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RESEARCH

THE ACS AND RESEARCH

The American Cancer Society is one of the largest sources of cancer research funds in the United States, second only to the National Cancer Institute, an agency of the Federal government.

The Society's overall investment in research each year has grown steadily from $1 million in 1946 to more than $64 million* today. This sum represents nearly a third of the total ACS budget. To date, the Society has invested more than half a billion dollars in cancer research.

The research program focuses primarily on investigator initiated projects, rather than directed research undertaken on a contract basis. With the exception of staff and facilities to carry out its epidemiological studies, the ACS neither hires staff researchers nor operates its own laboratories. This gives the Society the freedom to place its grants where innovative and promising ideas are being explored.

A key factor in the role of the Society in cancer research is providing qualified scientists with alternative funding sources to carry on their work. The Society believes it can make the most effective use of its research funds by supporting scientists working in established medical institutions across the country. In this way there is a minimum of overhead and a maximum of flexibility to make sure that research money has the highest probability of yielding results that will benefit people.

Applications for ACS grants are put through a rigorous process of evaluation, beginning with careful study by the appropriate one of 11 scientific review committees and two additional groups of experts. It must be given final approval by the National Board of Directors.

Kinds of Grants

The Society's research program is diverse in concept and recipients. It provides support both for established scientists and those starting out on their own independent research. It funds postdoctoral training for promising young investigators and stimulates new ideas in cancer research among those working in universities, institutes and teaching hospitals.

Overall, the program offers five types of grants: (1) Research and Clinical Investigation Grants to finance investigator-initiated research; (2) Institutional Research Grants to universities, institutes and hospitals to support pilot studies and the work of young investigators in cancer; (3) Research Personnel Grants to outstanding scientists and students specializing or planning to specialize in cancer research; (4) Research Development Programs to provide rapid funding for priority projects; and (5) Special Institutional Grants for Cancer Cause and Prevention Research to provide longer term funding.

Research Professorships. The Research Professorship grant program, unique in the field, has been in existence since 1957. The Society supports 23 of the nation's most gifted scientists through retirement. These are people devoting their life's work to cancer research. Freed of major administrative responsibilities and other restrictions, they can concentrate on their fields of scientific investigation.

Physicians' Training Fellowships. Unique in the research world, this type of Research Personnel Grant was inaugurated in 1981 because of a dearth of MD's in the research field. It provides an opportunity for physicians to take two years from their medical careers to train as researchers.

Research Development Program. Established to identify and provide rapid funding for high priority projects, approved applications can be funded in less than three months. This compares with the 10 to 18 months required by the Federal government before a new application can be funded.

The kinds of research project eligible under the Research Development Program include: (1) unique research opportunities which cannot wait for the normal lengthy funding procedures; (2) unanticipated needs relating to research already under way; (3) program coordination, especially that involving clinical trials and the dissemination of research results to community hospitals; and (4) program integration between the American Cancer Society and other health organizations.

All applications are evaluated for — among other considerations — merit, qualifications and productivity of the investigator; relevance, need for rapid funding, and probability of the project's eventual contribution to cancer control. More than $10 million has been appropriated so far to the Research Development Program, over half of which has been for interferon research.

Interferon Research. Interferon, a natural body protein, was discovered as an antiviral agent and later found to have some anticancer activity. In 1978, the Society invested an unprecedented $2 million to purchase interferon for clinical trials. The substance was extremely scarce and expensive, since it was obtained from human blood cells.

The first tests were performed on carefully selected patients in 15 U.S. institutions, and included 175 patients. Four types of cancer were in the study — multiple myeloma, melanoma, breast cancer and non-Hodgkin's lymphoma. Additional studies involving melanoma, advanced kidney cancer and nasopharyngeal cancer are being conducted at five institutions.

So far, a number of patients have shown some response to interferon, ranging from those whose steady downhill course was stabilized, to those whose tumors disappeared entirely. It is still too early to tell what the long-term effects will be.

In working with interferon, scientists discovered that there are at least three different types, each produced by different cells, and potentially capable of different activity. In addition, large quantities of interferon now can be produced using the techniques of recombinant DNA. It is far cheaper and purer than the original human blood substance.

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*Subject to audit

In early 1980 the Society allocated an additional $4.8 million for interferon research which in part permitted a study to be conducted using a different type of interferon, one produced by fibroblast cultures. This interferon is being studied at 12 institutions in advanced prostate cancer, glioblastoma multiforme and soft tissue sarcomas.

Besides the American Cancer Society, sponsors of interferon research in this country include the National Cancer Institute and the National Institute of Allergy and Infectious Diseases.

Ultimately, interferon may be valued not so much for itself, as for its role in heralding a whole new class of compounds called "biologic response modifiers," which will fight cancer by stimulating the body's immune system.

ACS Research in the 80's

In addition to ongoing interferon studies, ACS-funded researchers will continue to investigate broad areas of cancer research in the coming decade. For example, they will be exploring:

Genetic engineering. One method in this new technology, recombinant DNA (gene splicing) is already being used to produce interferon. It has among its potential uses the manufacture of powerful new drugs, correcting impaired immune systems, even modifying heredity by transplanting foreign genes. It is hoped that the process will yield other anticancer activities.

Man-made antibodies such as hybridomas (antibody factories) and highly specific monoclonal antibodies can be produced that will recognize cancer cells only, and thus be able to detect cancer early, when the disease is most curable, before clinical signs appear. Monoclonal antibodies already have been used to deliver drugs directly to tumors, killing them but sparing healthy issue,i.e., a rifle instead of a shotgun.

Mechanisms of carcinogenesis. Investigators are approaching these key questions from many angles. One model, as found in animals, shows that cancer in humans develops in a two-step process — initiation and promotion. Other questions include: Are there proto-oncogenes, normal genes, serving as master switches for early tissue development, which induce normal cells to become cancerous later in life? If so, what turns them on? Can they be programmed to stay off? Do viruses, already known to cause cancer in animals, also cause cancer in humans, perhaps by activation of these proto-oncogenes?

Chemoprevention. People can be protected from cancer by what they eat or drink, or by other substances or lifestyles that serve as defense mechanisms. Clues are being pursued by ACS researchers studying such agents as vitamin A; retinoids (synthetic forms of vitamin A); vitamin C; vitamin E; the chemical element selenium, found in the soil; and by other naturally occurring substances in brussels sprouts, cabbage, etc.

Still other ACS investigators are looking for ways to detect cancer earlier by tracing a cell's biochemical markers. They are exploring evidence that the outbreak of the rare skin cancer, Kaposi's sarcoma, is linked to a breakdown in the individual's immune system. And they are testing the hypothesis that certain chemicals enhance a tumor's receptivity to radiation therapy.

The Financial Research Picture

In fiscal 1984, the ACS made 674 grants to major institutions in this country and to scientists working here and abroad. The total amount, subject to audit, was nearly $58 million. This does not include some $2.5 million granted directly by ACS Divisions. The following table — covering the years 1981 to 1984 inclusive — lists the number of applications received, the total number of dollars required, and those actually funded by the ACS National Office. ACS allocated its funds to effectively carry out its three-pronged attack against cancer: Research, Education and Service.

	Requested		**Funded**	
Year	Number	Amount	Number	Amount
1981	2,069	230,936,242	672	51,960,530
1982	2,475	300,961,755	681	53,953,831
1983	2,564	336,760,146	646	54,132,563
1984	2,247	290,368,552	674	57,775,330

CANCER AND THE ENVIRONMENT

Most cancer cases in the United States are believed to be environmentally related, that is, associated in some way with our physical surroundings, personal habits or lifestyles.

Occupational hazards, although associated with only a small percentage of cancers, are under close surveillance. Virtually every suspected major chemical and other substance in the workplace presumed to be a health risk is under investigation. Each study can require years and hundreds of thousands of dollars to complete.

Some environmental causes of cancer are well known. About 30% of all cancers are directly related to the use of tobacco, either alone or in conjunction with excessive consumption of alcohol.

Other causes are harder to determine. Diet is suspected as an important element in cancer risk, some say as much as 35% of all cancer deaths. There is much research underway on the role diet and nutritution play in the development of cancer.

To help identify environmental factors in human cancer, the American Cancer Society has undertaken a three-part program of environmental cancer research. This involves (1) Cancer Prevention Study II, a new epidemiologic study to examine the relationship of environment and lifestyle to cancer development; (2) studies of groups exposed to industrial substances suspected of causing cancer; and (3) support of extramural cancer cause and prevention research projects.

The American Cancer Society's Cancer Prevention Study II

One of the largest research studies ever carried out in the United States was launched in 1982. Cancer Prevention Study II, a long-term prospective study, is examining the habits and exposures of more than one million Americans to learn how lifestyles and environmental factors affect the development of cancer

Modeled after the first ACS Cancer Prevention Study (1959-72), CPS-II is similar in method but wider in scope and involves more participants

Over 77,000 volunteers were mobilized to enroll 1.2 million men and women in the study. These volunteer researchers distributed a four-page confidential questionnaire to participants, who were asked about their exposures to certain environmental conditions, their history of disease and their lifestyle. The questionnaires were designed to elicit more than 500 pieces of information each, information which is computerized for statistical analysis.

Many of the questions focus on health issues of current concern. These include risks of certain drugs, foods and various occupational exposures; low-tar and nicotine cigarettes; consumer products; long-term exposure to low-level radiation, and the health effects associated with air and water pollution.

For a period of six years, and possibly longer, the volunteers will keep track of the status and whereabouts of study participants. The first follow-up started in September 1984. Follow-ups are also scheduled for 1986 and 1988. Various suspected relationships will be tested by comparing mortality rates of differently exposed groups.

The goal of the study is to identify those factors that increase a person's chances of developing cancer, those that carry little or no risk, and those that actually may help prevent cancer. With this information, the Society will be able to promote more effective educational programs in cancer prevention.

The Society's first Cancer Prevention Study resulted in important findings about health and disease. Study data provided overwhelming evidence that cigarette smoking is the major cause of lung cancer and an important factor in other cancers. It also furnished information on risks of heart disease and other serious illnesses, and revealed a relationship between obesity and certain cancers.

Since the first study, new factors in our environment have been identified that may be related to cancer. The Society decided to initiate a second study to respond to the concerns of the public and scientific community about suspected carcinogens.

Without the use of ACS volunteers, the cost of carrying out CPS II would total more than $100 million. With volunteers to collect the data, the study is estimated to cost only about $9 million to complete.

Studies of Occupational Groups

A number of studies of union workers exposed to various agents have been undertaken in the Society's Intramural Research Program; the findings will have considerable public health implications.

It has been established that asbestos workers have a high risk of lung cancer, gastrointestinal cancer and other conditions. Less clear, though, is the hazard asbestos exposure poses for the general population, particularly among people exposed to very low levels.

The ACS is studying the mortality of family members of asbestos factory workers and insulation workers to determine if they are at an increased risk of lung cancer and other asbestos-related diseases. A study of shipyard workers will offer data on this group's cancer incidence and mortality rates.

In a current study, it may be learned how smoking cessation affects the lung cancer risk of insulation workers who no longer work with asbestos materials.

Other occupational groups under continuing investigation include vinyl chloride workers, painters, rubber plant employees, those who work with polychlorinated biphenyls (PCB's), printing press workers, and health care and hospital employees.

Special Institutional Grants

As part of its continuing program to provide substantial and relatively long-term support for major institutions engaged in cancer cause and prevention research, the American Cancer Society awarded continuing grants to the following institutions in 1984:

- Institute of Environmental Medicine, New York University Medical Center, New York, N.Y. (Dr. Arthur C. Upton), to conduct a broad spectrum of studies dealing with such subjects as DNA interactions, risk assessment and nutrition.
- Massachusetts Institute of Technology, Boston, Mass. (Dr. Gerald N. Wogan), to use innovative techniques to detect changes in DNA, hemoglobin and albumin, and changes in T-cells that could signal relatively low exposures to carcinogens; together with the Harvard School of Public Health (Dr. Brian MacMahon) for biochemical studies of cancer risks, involving such groups as smokers, nonsmokers and those with particular dietary habits.
- Milton Hershey Medical Center, Pennsylvania State University, Hershey, Pa. (Dr. Fred Rapp), to research the cause, course and prevention of metastatic tumor growth.
- The American Health Foundation, New York, N.Y., to conduct epidemiologic studies, health behavior evaluations, and biochemical analyses of various consumer products.
- Temple University School of Medicine, Philadelphia, Pa., for an ongoing study of cancer prevention and analyses of chemical and environmental carcinogens.
- Memorial Sloan-Kettering Cancer Center, New York, N.Y., to identify candidates at high risk of colorectal cancer.
- University of Minnesota, Minneapolis, for a study of inhibitors of carcinogenesis found in diet.
- Mount Sinai School of Medicine, New York, N.Y., for collecting and disseminating information on reported environmental carcinogens.
- The Johns Hopkins University School of Medicine, Baltimore, Md., to develop new methods of protecting against cancer-causing influences, with special emphasis on the hazards of medical drugs.
- The University of Southern California School of Medicine, Los Angeles, to study the possible relationship of cancer to specific occupational, drug or other environmental exposures.

SUMMARY OF RESEARCH GRANTS & FELLOWSHIPS AWARDED BY ACS (National Society & Divisions) DURING THE FISCAL YEAR ENDED AUGUST 31, 1984 (Subject to Audit)

Alabama, Univ. of, Birmingham	(4)	210,062.00
Albany Medical Coll. of Union Univ., Albany, NY	(1)	49,706.00
Amer. Type Culture Collection, Rockville, MD	(1)	14,062.00
Arizona State Univ., Tempe	(1)	45,000.00
Arizona Univ., Tucson	(1)	22,277.00
Arkansas, Univ. of, Fayetteville	(1)	191,006.00
Baylor Coll. of Medicine, Houston, TX	(4)	252,706.00
Beth Israel Hosp., Boston, MA	(2)	146,750.00
Boston Univ., Boston MA	(4)	450,000.00
Brandeis Univ., Waltham, MA	(3)	205,000.00
Brown Univ., Providence, RI	(6)	520,857.00
California Inst. of Tech., Pasadena, CA	(3)	170,078.00
California, Univ. of (various locations)	(70)	5,665,218.00
Carnegie Inst. of Washington, Baltimore, MD	(5)	322,250.00
Case Western Reserve Univ., Cleveland, OH	(6)	455,670.00
Chicago, Univ. of, IL	(12)	1,297,431.00
Children's Cancer Res. Fdn., Boston, MA	(2)	119,825.00
Children's Hosp. of Philadelphia, PA	(3)	56,241.00
Children's Hosp. Medical Ctr. of Northern Calif., Oakland	(1)	90,000.00
Children's Hosp. Soc., Los Angeles, CA	(2)	276,266.00
Cincinnati, Univ. of, OH	(3)	219,505.00
Clark Univ., Worcester, MA	(1)	42,000.00
Col[illegible] Lab., NY	(3)	290,000.00
Coll. of Medicine and Dentistry of New Jersey	(2)	100,907.00
Colorado State Univ., Fort Collins	(1)	214,571.00
Colorado, Univ. of, Boulder	(10)	679,606.00
Columbia Univ., New York, NY	(8)	792,800.00
Connecticut, Univ. of, Storrs	(2)	126,135.00
Cornell Univ., Ithaca, NY	(1)	149,101.00
Cornell Univ., New York, NY	(2)	121,690.00
Dartmouth Coll., Hanover, NH	(4)	251,054.00
Delaware, Univ. of, Newark	(1)	95,047.00
Duke Univ., Durham, NC	(7)	920,448.00
Emory Univ., Atlanta, GA	(2)	215,000.00
Florida, Univ. of, Gainesville	(2)	62,355.00
Fred Hutchinson Cancer Res. Ctr., Seattle, WA	(1)	89,000.00
Hahnemann Medical Coll., Philadelphia, PA	(2)	139,376.00
Harvard Sch. of Pub. Health, Boston, MA	(2)	330,000.00
Harvard Univ., Boston, MA	(17)	980,019.00
Hawaii, Univ. of, Honolulu	(3)	112,482.00
Hospital for Joint Diseases, New York, NY	(1)	125,000.00
Hunter Coll. Organized Res., New York, NY	(1)	28,605.00
Illinois, Univ. of, Urbana	(4)	245,934.00
Indiana, Univ. of, Bloomington	(3)	296,240.00
Inst. for Cancer Res., Philadelphia, PA	(3)	270,325.00
Iowa, State Univ., of, Iowa City	(4)	430,778.00
Jackson Laboratory, Bar Harbor, ME	(2)	207,750.00
Jefferson Medical Coll., Philadelphia, PA	(1)	146,100.00
Jewish Hosp. of St. Louis, MO	(1)	170,563.00
Johns Hopkins Univ., Baltimore, MD	(18)	1,603,084.00
Kansas State Univ., Manhattan	(1)	110,000.00
Kansas, Univ. of, Lawrence	(4)	495,720.00
Kentucky, Univ. of, Lexington	(2)	148,046.00
La Jolla Cancer Res. Fdn., La Jolla, CA	(1)	48,488.00
Lankenau Hosp., Philadelphia, PA	(1)	120,000.00
Linus Pauling Inst. of Science and Medicine, Palo Alto, CA	(1)	136,772.00
Long Island Coll. Hosp., Brooklyn, NY	(1)	94,600.00
Louisiana State Univ., Baton Rouge	(1)	20,000.00
Louisville, Univ. of, Louisville, KY	(2)	115,000.00
Maryland, Univ. of, Baltimore	(7)	739,804.00
Massachusetts General Hosp., Boston	(5)	880,775.00
Massachusetts Inst. of Technology, Cambridge	(12)	798,044.00
Massachusetts, Univ. of, Amherst	(3)	308,945.00
Miami, Univ. of, Coral Gables, FL	(2)	316,325.00
Michigan Molecular Inst., Midland	(1)	127,253.00
Michigan, Univ. of, Ann Arbor	(8)	1,009,396.00
Minnesota, Univ. of, Minneapolis	(8)	693,219.00
Missouri, Univ. of, Columbia	(1)	147,159.00
Montefiore Hosp., New York, NY	(1)	166,898.00
Mount Sinai Sch. of Medicine, New York, NY	(9)	1,017,495.00
Nat'l Acad. of Sciences, Washington, DC	(1)	34,000.00
Nat'l Cancer Inst., Bethesda, MD	(2)	48,280.00
Nat'l Inst. of Child Health and Human Development, Bethesda, MD	(1)	32,520.00
Nat'l Inst. of Dental Res., Bethesda, MD	(1)	32,079.00
Nat'l Jewish Hosp. and Res. Ctr., CO	(4)	453,896.00
Nat'l Soc. for Medical Res., Washington, DC	(1)	10,000.00
NCI-Biology Laboratory of Viruses	(1)	32,060.00
NCI-Laboratory of Cell Biology	(1)	32,120.00
New England Medical Ctr. Hosp., Boston, MA	(3)	313,491.00
New England Regional Primate Res. Ctr., Southborough, MA	(1)	200,000.00
New Mexico, Univ. of, Albuquerque	(2)	133,339.00
New York State Dept. of Health, Albany	(1)	32,000.00
New York State Psychiatric Inst.	(1)	10,000.00
New York Univ., New York, NY	(5)	354,440.00
North Carolina, Univ. of, Chapel Hill	(9)	650,955.00
Northwestern Univ., Chicago, IL	(4)	221,000.00
Oak Ridge Assoc. Univs. Inc., Oak Ridge, TN	(1)	86,331.00
Ohio State Univ., Columbus	(3)	213,978.00
Oregon State College, Corvallis	(3)	149,863.00
Oregon, Univ. of, Eugene	(4)	296,500.00
Pennsylvania Hospital, Philadelphia	(1)	17,125.00
Pennsylvania State Univ., University Park	(5)	189,140.00
Pennsylvania, Univ. of, Philadelphia	(7)	563,665.00
Peter Bent Brigham Hosp., Boston, MA	(2)	215,109.00
Pittsburgh, Univ. of, Pittsburgh, PA	(6)	473,013.00
Princeton Univ., Princeton, NJ	(3)	240,000.00
Pub. Health Res. Inst., New York, NY	(1)	84,932.00
Purdue Univ., Lafayette, IN	(5)	337,237.00
Reed College, Portland, OR	(1)	120,000.00
Rochester, Univ. of, Rochester, NY	(5)	520,000.00
Rockefeller Univ., New York, NY	(9)	591,886.00
Roger Williams General Hosp., Providence, RI	(1)	58,673.00
Roswell Park Memorial Inst., Buffalo, NY	(13)	1,595,760.00
Salk Inst. for Biological Studies, San Diego, CA	(5)	133,875.00
Scripps Clinic Res. Fdn., La Jolla, CA	(5)	324,059.00
Sidney Farber Cancer Ctr., Boston, MA	(14)	1,119,631.00
Sloan-Kettering Inst. for Cancer Res., New York, NY	(23)	2,769,229.00
Sloan-Kettering Inst., Westchester, NY	(1)	68,901.00
South Carolina, Univ. of, Columbia	(4)	413,139.00
Southern California, Univ. of, Los Angeles	(5)	385,365.00
Southern Res. Inst., Birmingham, AL	(2)	199,779.00
St. Jude Children's Res. Hosp., Memphis, TN	(3)	175,730.00
St. Louis Univ., St. Louis, MO	(3)	226,216.00
Stanford Univ., Stanford, CA	(16)	1,192,875.00
State Univ. of New York, Albany, NY	(1)	55,730.00
State Univ. of New York, Brooklyn, NY	(2)	235,444.00
State Univ. of New York, Buffalo, NY	(3)	208,181.00
State Univ. of New York, Stony Brook, NY	(8)	680,756.00
Swarthmore Coll., Swarthmore, PA	(1)	13,200.00
Syracuse Univ., Syracuse, NY	(2)	277,510.00
Temple Univ., Philadelphia, PA	(3)	259,729.00
Tennessee, Univ. of, Memphis	(2)	238,988.00
Texas A&M Res. Fdn., College Station	(1)	160,000.00
Texas Tech. Univ. Health Sciences Ctr.	(1)	120,000.00
Texas, Univ. of (various locations)	(24)	2,262,238.00
Tufts Univ., Medford, MA	(5)	310,291.00
Tulane Univ., New Orleans, LA	(2)	140,000.00
Université Louis Pasteur, France	(1)	33,400.00
Utah, Univ. of, Salt Lake City	(4)	392,485.00
Vanderbilt Univ., Nashville, TN	(5)	205,273.00
Vermont, Univ. of, State Agr. Coll., Burlington	(2)	200,354.00
Veterans Admin. Hosp., Bronx, NY	(1)	18,400.00
Vincent T. Lombardi Cancer Res. Ctr., Wash., DC	(1)	68,545.00
Virginia Medical Coll. of Richmond	(2)	112,933.00
Virginia, Polytechnic Inst. and State Univ. of, Blacksburg	(1)	200,000.00
Virginia, Univ. of, Charlottesville	(9)	911,262.00
W. Alton Jones Cell Science Ctr., Lake Placid, NY	(2)	375,000.00
Wake Forest College, Winston-Salem, NC	(5)	544,134.00
Washington State Univ., Pullman	(1)	25,000.00
Washington, Univ. of, Seattle	(9)	757,377.00
Washington Univ., St. Louis, MO	(3)	147,317.00
Wayne State Univ., Detroit, MI	(1)	59,617.00
Whitehead Inst. Bio-Medical Res., Cambridge, MA	(3)	170,000.00
Wisconsin, Univ. of, Madison	(13)	938,016.00
Wistar Inst. of Anat. and Bio., Philadelphia, PA	(4)	661,212.00
Worcester Fdn. for Experimental Bio., Shrewsbury, MA	(2)	210,000.00
Wyoming, Univ. of, Laramie	(1)	40,000.00
Yale Univ., New Haven, CT	(32)	2,451,087.00
Yeshiva Univ., Bronx, NY	(13)	816,356.00
Professional Programs of the UICC	(2)	515,000.00
SUBTOTAL	(674)	57,775,330.00
Division Research Grants		2,500,000.00
TOTAL		60,275,330.00

NOTE: Numbers in parentheses indicate number of grants per institution for the year ended August 31, 1984, totals subject to audit.

THE AMERICAN CANCER SOCIETY

PROFILE

The American Cancer Society, Inc. is a national voluntary health organization of 2.5 million Americans united to conquer cancer through balanced programs of research, education, patient service and rehabilitation.

Organization: The American Cancer Society, Inc. is composed of a National Society, with 58 chartered Divisions and 3,242 Units.

The National Society: A 200-member House of Delegates provides a basic representation from the 58 Divisions and additional representation on the basis of population. It elects and is governed by a Board of Directors of 121 voting members, approximately half of whom are members of the medical or scientific professions.

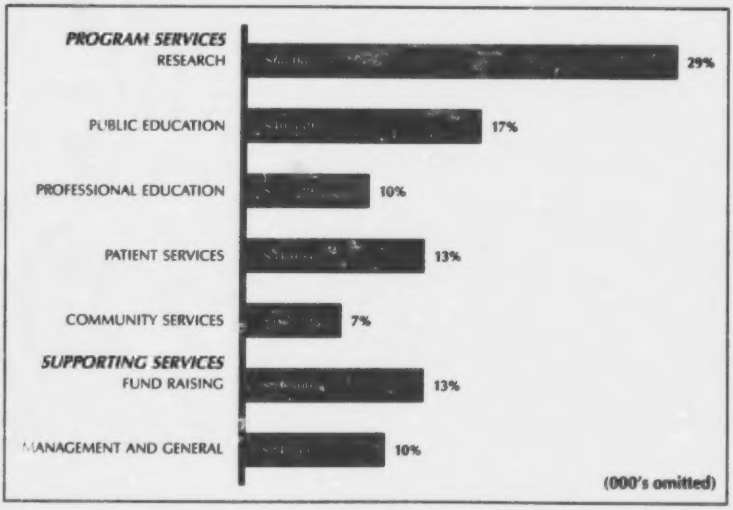
The National Society is responsible for overall planning and coordination, and provides technical help and materials to Divisions and Units. The National Society administers programs of research, medical grants and clinical fellowships, and is charged with carrying out public and professional education on the national level.

The 58 Divisions: These are governed by 3,847 members of Divisional Boards of Directors, both medical and lay, in all the states plus six metropolitan areas, the District of Columbia and Puerto Rico.

The Units: These are organized to cover the 3,130 counties in the United States. There are thousands of community leaders who direct the Society's programs at this level. The basic strength of the Society lies in the loyal ranks of volunteers fighting cancer in their communities.

The Programs: The Society maintains its priorities and goals through activities developed by the departments of Research, Professional Education, Public Education, Public Information, Epidemiology and Statistics, Service and Rehabilitation, and Crusade.

ALLOCATION OF ACS FUNDS BASED ON TOTAL 1983-1984 BUDGET—$236,190,000



Figures taken from 1983 Annual Report

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SOURCES OF INCOME

Financial support of the American Cancer Society in fiscal 1984 is estimated to exceed $215 million from public sources. The Cancer Crusade raised about $165 million. National Headquarters and chartered Divisions received some $50 million from bequests and legacies. The public has given generous and growing support to the Society over the years. In 1946, for example, funds raised exceeded $10 million. Thirty-five years later, in 1981, that figure had soared to more than $170 million.

Legacies — in which the Society becomes beneficiary of willed funds — are an increasingly important source of ACS income. Income from legacies indicates confidence in the leadership of the Society and a determination by many Americans to continue the fight against cancer even after their lifetimes. Legacy income in relation to Crusade receipts is shown below.

Year	Crusade	Legacies
197[illegible]	72,152,000	24,117,000
1975	78,788,000	31,056,000
1976	84,882,000	33,968,000
1977	90,120,000	24,606,000
1978	95,928,000	30,179,000

Year	Crusade	Legacies
1979	102,778,000	39,361,000
1980	113,325,000	41,366,000
1981	124,615,000	45,793,000
1982	135,197,000	47,800,000
1983	151,181,000	51,908,000

CANCER'S SEVEN WARNING SIGNALS

1. Change in bowel or bladder habits
2. A sore that does not heal
3. Unusual bleeding or discharge
4. Thickening or lump in breast or elsewhere
5. Indigestion or difficulty in swallowing
6. Obvious change in wart or mole
7. Nagging cough or hoarseness

If you have a warning signal, see your doctor.

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CANCER AROUND THE WORLD, 1978-1979

Age-Adjusted Death Rates Per 100,000 Population for Selected Sites for 48 Countries

COUNTRY	ALL SITES		ORAL		COLON & RECTUM		LUNG		BREAST	UTERUS	STOMACH		PROSTATE	LEUKEMIA	
	Male	Female	Male	Female	Male	Female	Male	Female	Female	Female	Male	Female	Male	Male	Female
United States*	216.9(18)	137.7(19)	5.8(14)	1.9(7)	26.5(15)	20.2(15)	70.3(9)	19.0(5)	27.1(14)	8.4(37)	8.6(43)	4.3(44)	22.9(13)	8.7(7)	5.2(6)
Argentina*	215.9(19)	139.3(17)	4.5(22)	0.8(38)	20.5(24)	17.5(21)	56.9(22)	9.5(16)	24.7(16)	14.7(12)	23.5(26)	11.6(26)	18.9(24)	6.0(28)	4.4(24)
Australia	212.4(21)	125.4(29)	5.4(18)	1.7(10)	28.4(11)	21.8(10)	62.0(18)	11.5(14)	23.2(20)	7.5(39)	14.9(39)	7.2(40)	22.7(16)	7.7(17)	4.6(21)
Austria	247.3(9)	147.6(12)	5.5(17)	0.8(38)	32.0(3)	21.6(12)	66.8(12)	9.3(17)	23.2(20)	14.2(14)	36.8(8)	18.5(10)	22.2(15)	7.3(21)	4.8(17)
Barbados**	179.0(30)	136.1(21)	9.1(7)	1.4(19)	5.1(41)	14.4(27)	12.6(41)	5.8(34)	27.4(12)	30.0(1)	33.7(11)	12.4(23)	41.2(1)	8.9(3)	1.4(45)
Bulgaria	156.3(38)	102.6(37)	2.5(38)	0.9(34)	14.4(33)	11.1(33)	43.6(26)	7.4(25)	15.8(30)	9.4(30)	33.4(12)	20.5(7)	9.0(38)	5.2(35)	4.0(31)
Canada*	214.9(20)	136.1(20)	6.0(11)	1.7(10)	29.7(9)	23.1(8)	65.5(13)	14.2(11)	27.8(11)	8.5(35)	14.4(40)	6.7(42)	21.9(18)	8.4(8)	5.1(10)
Chile	191.3(26)	148.5(10)	3.5(30)	0.7(41)	9.6(35)	9.9(36)	24.9(36)	6.8(30)	14.1(35)	21.1(5)	61.8(3)	28.1(3)	16.5(29)	4.4(38)	5.1(10)
Costa Rica	178.6(31)	138.3(18)	3.4(31)	1.1(27)	7.7(37)	8.5(38)	15.6(40)	7.1(27)	9.9(38)	18.5(7)	62.1(2)	33.5(1)	14.8(31)	7.1(22)	6.3(1)
Cuba*	172.1(34)	119.3(31)	9.2(6)	2.2(6)	13.4(32)	15.1(25)	50.1(24)	16.6(8)	17.9(25)	17.6(9)	13.1(41)	7.1(41)	23.3(11)	5.7(30)	4.1(30)
Denmark	233.3(13)	172.3(1)	4.0(26)	1.9(7)	34.0(1)	26.1(2)	68.6(11)	17.2(7)	30.6(6)	14.4(13)	18.5(34)	10.2(31)	23.2(12)	9.0(2)	5.7(2)
Dominican Rep.*	51.7(45)	48.1(45)	1.9(43)	1.6(16)	4.3(43)	3.7(42)	5.6(44)	3.0(44)	4.1(44)	8.8(34)	4.3(44)	2.2(45)	8.6(39)	2.1(44)	1.5(44)
Ecuador*	87.3(42)	86.9(40)	1.2(46)	0.6(45)	3.1(44)	3.9(41)	5.9(43)	2.3(45)	6.0(42)	23.0(4)	31.8(14)	20.5(7)	10.5(37)	2.9(41)	2.5(41)
Egypt*	39.0(47)	18.8(48)	0.6(47)	0.2(47)	2.3(45)	1.1(47)	2.5(47)	1.1(47)	3.4(45)	2.0(47)	1.9(46)	1.1(46)	1.5(46)	2.3(43)	1.4(45)
England & Wales	248.7(8)	156.9(5)	3.6(29)	1.7(10)	28.4(11)	21.7(11)	95.7(3)	20.7(4)	33.8(1)	10.2(26)	24.0(25)	11.4(27)	18.3(25)	7.0(23)	4.5(22)
Fiji*	54.0(44)	79.8(41)	1.8(44)	3.4(3)	4.7(42)	3.0(43)	4.0(45)	5.7(35)	7.9(40)	28.5(2)	9.5(42)	4.9(43)	3.3(45)	2.4(42)	5.2(6)
Finland*	243.9(10)	113.9(32)	3.7(28)	1.4(19)	15.7(27)	13.3(28)	86.5(5)	6.5(31)	17.6(26)	8.1(38)	30.7(16)	15.0(18)	24.0(8)	8.8(5)	4.3(25)
France*	255.7(6)	120.8(30)	18.3(2)	1.4(19)	27.5(13)	18.1(20)	51.8(23)	4.9(41)	21.9(24)	10.7(25)	18.0(35)	8.6(37)	22.0(17)	8.9(3)	5.3(3)
Germany, F.R.	242.0(11)	152.0(8)	4.1(24)	0.9(34)	31.3(5)	23.9(7)	36.0(29)	7.2(28)	25.3(15)	11.5(19)	30.6(17)	16.3(12)	23.9(9)	7.8(15)	5.2(6)
Greece	188.3(28)	103.6(36)	2.2(40)	0.8(38)	8.3(36)	7.7(40)	58.5(21)	8.8(18)	16.2(29)	7.3(41)	17.3(36)	9.8(33)	11.0(36)	8.4(8)	4.7(20)
Guatemala*	68.6(43)	78.8(42)	2.2(40)	1.0(30)	2.0(46)	2.5(44)	2.7(46)	2.0(46)	2.7(46)	12.6(16)	21.6(29)	18.9(9)	4.9(41)	1.5(47)	1.1(47)
Hong Kong	235.2(12)	125.5(28)	20.9(1)	7.2(1)	19.2(25)	12.8(29)	68.9(10)	30.9(1)	10.7(37)	8.5(35)	19.6(32)	9.1(36)	1.7(44)	5.5(31)	3.9(34)
Hungary	269.3(3)	162.6(3)	8.2(8)	1.6(16)	30.5(7)	23.0(9)	72.5(7)	12.1(13)	24.6(17)	18.1(8)	44.6(4)	20.9(4)	24.2(7)	7.7(17)	5.2(6)
Iceland	150.7(39)	140.7(16)	2.0(42)	2.6(4)	16.2(26)	15.1(25)	28.3(34)	16.5(9)	27.2(13)	6.6(44)	26.3(21)	12.9(22)	14.0(33)	9.6(1)	3.7(36)
Ireland*	219.0(17)	158.0(4)	5.7(16)	1.7(10)	32.0(4)	26.0(3)	60.5(20)	17.8(6)	32.1(4)	7.3(41)	21.7(27)	14.4(19)	21.9(19)	6.3(25)	4.5(22)
Israel	174.7(32)	145.9(13)	1.7(45)	0.9(34)	22.7(22)	18.2(17)	12.9(41)	10.5(15)	28.3(10)	6.5(45)	15.9(38)	9.8(33)	13.1(34)	8.8(5)	4.8(17)
Italy	228.5(15)	126.0(27)	7.3(11)	1.1(27)	23.5(21)	17.5(21)	61.8(19)	7.1(27)	22.3(23)	11.4(21)	31.3(15)	15.7(15)	15.8(30)	8.0(12)	5.1(10)
Japan	190.0(27)	109.3(33)	2.4(39)	0.8(38)	15.5(29)	11.4(32)	31.2(33)	8.8(18)	6.0(42)	9.3(31)	66.1(1)	31.2(2)	3.9(42)	4.8(37)	3.2(39)
Luxembourg	269.0(4)	148.3(11)	9.7(5)	0.3(46)	31.3(5)	24.6(4)	87.5(4)	8.6(20)	24.4(18)	13.0(15)	26.9(20)	12.1(25)	20.7(20)	7.9(14)	5.3(3)
Mauritius	100.0(41)	71.6(44)	4.1(24)	0.7(43)	5.7(40)	2.5(44)	21.2(37)	5.2(39)	6.6(41)	10.5(23)	21.4(30)	9.6(35)	5.4(40)	1.9(45)	1.8(42)
Netherlands	266.2(5)	144.8(14)	2.6(36)	1.0(30)	26.4(16)	21.3(14)	101.2(2)	6.8(30)	31.9(5)	9.0(33)	25.5(22)	11.3(29)	24.3(6)	8.2(10)	5.3(3)
New Zealand	172.0(35)	154.4(7)	4.9(19)	1.7(10)	33.3(2)	29.5(1)	64.4(14)	16.1(10)	30.0(7)	9.8(28)	16.9(37)	7.5(39)	22.7(14)	7.6(19)	5.0(13)
Nicaragua*	22.9(48)	35.9(46)	0.0(48)	0.0(48)	0.1(48)	0.5(48)	1.4(48)	0.0(48)	0.0(48)	0.4(48)	0.1(47)	0.5(48)	0.0(48)	1.6(46)	1.8(42)
Northern Ireland*	226.0(16)	151.7(9)	3.3(33)	1.8(9)	28.5(10)	24.1(6)	74.0(6)	14.2(11)	32.5(3)	7.5(39)	24.8(23)	14.1(20)	19.3(23)	8.1(11)	4.9(15)
Norway	193.8(25)	130.4(23)	3.1(34)	1.1(27)	24.0(19)	19.7(16)	31.7(32)	6.3(33)	23.6(19)	10.2(26)	21.1(31)	10.6(30)	31.1(3)	7.8(15)	4.9(15)
Poland	214.2(22)	126.2(26)	5.8(14)	1.3(23)	15.2(30)	11.7(31)	63.6(16)	7.9(23)	16.6(28)	15.0(11)	41.0(5)	16.2(14)	12.2(35)	6.6(24)	4.2(28)
Portugal	186.3(29)	108.0(34)	6.6(12)	1.3(23)	22.4(23)	17.3(24)	25.4(35)	4.2(42)	17.6(26)	12.3(17)	40.6(6)	20.9(4)	21.8(19)	6.3(25)	4.3(25)
Puerto Rico**	157.3(37)	95.1(39)	10.0(4)	1.6(16)	6.4(39)	7.9(39)	19.2(39)	5.6(37)	9.2(39)	7.3(41)	NA	8.5(38)	17.6(26)	5.1(36)	4.3(25)
Romania*	161.7(36)	106.0(35)	3.8(27)	1.0(30)	10.2(34)	9.0(37)	38.3(28)	7.0(29)	14.2(34)	18.7(6)	35.4(9)	15.7(15)	20.2(21)	5.3(33)	3.4(38)
Scotland	275.0(1)	172.0(2)	4.2(23)	1.7(10)	30.4(8)	24.6(4)	113.2(1)	27.5(2)	33.2(2)	9.8(28)	24.5(24)	12.3(24)	17.4(27)	6.3(25)	4.2(28)
Singapore	249.6(7)	130.4(24)	16.9(3)	5.8(2)	23.9(20)	18.2(17)	71.9(8)	21.2(3)	15.5(32)	11.3(22)	39.6(7)	16.3(12)	3.9(42)	4.4(38)	4.0(31)
Spain*	194.9(24)	75.1(43)	4.6(21)	0.8(38)	15.7(27)	12.8(29)	41.2(27)	5.0(40)	15.8(30)	9.5(29)	28.7(18)	15.4(17)	19.4(22)	5.4(32)	3.9(34)
Sweden	198.0(23)	141.2(15)	3.4(31)	1.4(19)	24.2(18)	18.2(17)	34.4(30)	8.5(21)	22.9(22)	9.1(32)	19.1(33)	10.0(32)	31.0(2)	8.0(12)	5.7(10)
Switzerland	230.3(14)	134.2(22)	7.6(9)	1.3(23)	25.8(17)	17.5(21)	62.6(17)	5.6(36)	29.5(8)	10.8(24)	21.7(27)	11.4(27)	27.7(4)	7.4(20)	4.8(17)
Thailand	46.2(46)	30.4(47)	2.6(36)	1.3(23)	1.9(47)	1.2(46)	6.5(42)	4.2(42)	1.2(47)	4.2(46)	2.1(45)	0.8(47)	0.2(47)	0.7(48)	0.5(48)
Uruguay*	271.8(2)	156.2(6)	7.6(9)	1.0(30)	27.0(14)	21.4(13)	63.9(15)	5.5(38)	29.2(9)	15.2(10)	32.6(13)	16.8(11)	27.6(5)	5.8(29)	5.0(13)
Venezuela*	115.0(40)	128.9(25)	3.1(34)	2.6(4)	7.1(38)	10.1(35)	20.4(38)	8.3(22)	11.5(36)	27.7(3)	34.0(10)	20.7(6)	16.8(28)	5.3(33)	3.6(37)
Yugoslavia*	172.7(33)	102.4(38)	4.8(20)	0.9(34)	13.1(33)	10.2(34)	46.3(25)	7.6(24)	14.5(33)	11.8(18)	27.9(19)	13.8(21)	14.7(32)	3.3(40)	2.0(40)

NOTE Figures in parentheses are order of rank within site and sex group. *1978 only **1979 only NA Not available Source of data World Health Statistics Annual 1980-1982

STATEMENT OF
THE BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL
ON
THE PRESIDENT'S TAX REFORM PLAN - TREASURY II

SUBMITTED BY

NOEL R. LEARY

EXECUTIVE VICE PRESIDENT

TO

THE FINANCE COMMITTEE

OF THE

UNITED STATES SENATE

JULY 16, 1985

BOMA WAS FOUNDED IN 1908 AND HAS A MEMBERSHIP OF NEARLY 6,000 INDIVIDUALS REPRESENTING 2.3 BILLION SQUARE FEET OF OFFICE SPACE IN NORTH AMERICA. BOMA'S MEMBERSHIP, CONSISTING OF OFFICE BUILDING DEVELOPERS, OWNERS, MANAGERS, SERVICE COMPANIES, BROKERS AND INVESTORS EMPLOY TENS OF THOUSANDS OF TAXPAYERS. IN ADDITION, MANY THOUSANDS OF OTHER WORKERS ARE EMPLOYED BY OUR MEMBERSHIP THROUGH THE VENDORS AND CONTRACTORS WHO SUPPLY GOODS AND SERVICES TO OUR INDUSTRY. AMONG THOSE WHO RECENTLY ATTENDED OUR NATIONAL TRADE

SHOW WERE REPRESENTATIVES OF THE TELECOMMUNICATIONS, ELEVATOR, AIR CONDITIONING, MAINTENANCE, AND ENGINEERING INDUSTRIES, TO NAME JUST A FEW.

OVER 40% OF ALL WORKERS IN AMERICA WORK IN OFFICE BUILDINGS. THIS PERCENTAGE IS RISING. THE OFFICE BUILDING INDUSTRY HAS BEEN A VITAL PART OF THE GENERAL ECONOMIC BOOM OF THE PAST SEVERAL YEARS. THOSE OF US WHO LIVE IN THE WASHINGTON, D.C. AREA, FOR INSTANCE, CAN ATTEST TO THE VITALITY OF THE OFFICE BUILDING INDUSTRY.

LIKE MANY OTHERS, WHAT FORM A TAX REFORM BILL MAY TAKE IS OF VITAL IMPORTANCE TO US. WE HAVE STUDIED IT CAREFULLY; OUR MEMBERS AT OUR ANNUAL CONVENTION TWO WEEKS AGO WERE EXPOSED TO A BROAD RANGE OF INFORMATION REGARDING THE PRESIDENT'S PROPOSAL, AND WE HAVE DISCUSSED IT WITH OTHER REAL ESTATE INDUSTRY REPRESENTATIVES.

BOMA'S ASSESSMENT OF THE PRESIDENT'S TAX REFORM PROPOSAL IS THAT THERE IS A DIVERGENCE OF OPINION AMONGST OUR MEMBERS ON THE SUBJECT QUITE SIMILAR TO RECENT NATIONAL SURVEYS. SOME ARE PREPARED TO ACCEPT THE ARGUMENT OF THE PRESIDENT THAT HIS PLAN WILL BE GOOD FOR AMERICA AND GOOD FOR THE ECONOMY. OTHERS ARE CONVINCED THAT THE PLAN REPRESENTS NOTHING LESS THAN A FRONTAL ASSAULT ON THE REAL ESTATE INDUSTRY.

IN VIEW OF THE BROAD DIVERGENCE WITHIN OUR MEMBERSHIP, OUR TESTIMONY WILL FOCUS ON SOME RELATIVELY NARROW POINTS. OUR OVERALL POSITION FOR NOW IS THIS: AS TAXPAYERS, WE HOPE TO SUPPORT THE

PRESIDENT'S TAX PROPOSALS FOR FAIRNESS, GROWTH AND SIMPLICITY; HOWEVER AS BUSINESS PEOPLE, TO THE EXTENT THAT PROVISIONS ARE TRADED OFF, TO THE BENEFIT OF ONE GROUP AND THE DETRIMENT OF OTHERS, OUR GOAL WILL BE TO DEFEND THE OFFICE BUILDING INDUSTRY BY OPPOSING PROVISIONS WHICH ARE UNFAIR AND COSTLY TO COMMERCIAL REAL ESTATE.

WE HAVE NOT PRIORITIZED OUR CONCERNS AS AN ASSOCIATION; IN FACT, WE BELIEVE THERE IS A DANGER--AT THIS STAGE OF THE PROCESS--IN STAKING OUT STRONG POSITIONS ON INDIVIDUAL POINTS. WE PREFER TO ASSESS THE RELATIVE MERITS OF THE PRESIDENT'S PLAN AS OTHER TAXPAYERS, THE CONGRESS, AND THE ADMINISTRATION DEBATE ITS EFFECTS OVER THE COURSE OF THE NEXT FEW MONTHS.

OUR AREAS OF CONCERN ARE THESE: RECAPTURE OF EXCESS DEPRECIATION, EXTENSION OF "AT RISK" RULES TO REAL ESTATE, THE CHANGE IN THE RELATIVE REAL ESTATE USE OF THE CAPITAL GAINS TAX RATES, ELIMINATION OF REHABILITATION TAX CREDITS, THE DRAWING OUT OF DEPRECIATION SCHEDULES FOR REAL ESTATE, AND THE INVESTMENT INTEREST LIMITATIONS.

TAKEN AS A WHOLE, THESE PARTICULAR PROVISIONS COULD FORETELL A WHOLESALE SHIFT IN REAL ESTATE OWNERSHIP. AT THE PRESENT TIME, THERE IS A WIDESPREAD MIX OF OWNERSHIP AMONG MILLIONS OF SMALL AND LARGE INVESTORS, CORPORATIONS AND MONEY FUNDS.

RELATIVE TO CURRENT LAW, MANY PEOPLE IN OUR INDUSTRY ARE CONCERNED THAT THESE PROVISIONS WILL DIVERT LARGE AMOUNTS OF INVESTMENT CAPITAL FROM COMMERCIAL REAL ESTATE. WE BELIEVE THIS WOULD RESULT IN A REDUCTION IN AVAILABLE VENTURE CAPITAL..THUS PROVIDING OPPORTUNITY FOR ONLY THE LARGER REAL ESTATE OWNER OR INVESTOR.

OF PARTICULAR CONCERN REGARDING CAPITALIZATION ARE THE FOLLOWING PROPOSALS -- TO EXTEND "AT RISK" RULES TO REAL ESTATE,

-- TO LIMIT INVESTMENT INTEREST DEDUCTIONS,

-- TO ELIMINATE CAPITAL GAINS TAX TREATMENT FOR DEPRECIABLE REAL ESTATE.

INDEED, EXTENSION OF THE "AT RISK" RULES ALONE WILL HAVE AN ENORMOUSLY ADVERSE IMPACT ON THE ABILITY TO RAISE CAPITAL FAR BEYOND THE RELATIVELY INSIGNIFICANT REVENUE IMPACT FOR THE TREASURY. BECAUSE OF THIS, WE WOULD URGE A MODIFICATION OF THIS PART OF THE PRESIDENT'S PLAN.

MOST OF THOSE IN THE REAL ESTATE INDUSTRY CANNOT BE EXPECTED TO ENJOY SEEING THE PROPOSED REAL ESTATE DEPRECIATION EXTENDED FROM 18 TO 28 YEARS. THIS REPRESENTS A COMPLETE TURN-ABOUT FROM THE 1981 TAX ACT; HOWEVER, IT REMAINS AN AREA IN WHICH THERE MAY BE ROOM FOR REASONABLE COMPROMISE.

WITH RESPECT TO THE PROPOSED ELIMINATION OF REHABILITATION TAX CREDITS, THE ADMINISTRATION'S ARGUMENTS ARE SORELY LACKING IN ANALYSIS AND PERSPECTIVE. WE WOULD SUPPORT A MODIFICATION OF THE PRESENT LAW, BUT THE BENEFICIAL EFFECTS OF THESE CREDITS HAS BEEN, WE THINK, SELF-EVIDENT.

OUR FINAL COMMENT RELATES TO THE SUGGESTED RECAPTURE OF SO-CALLED EXCESS DEPRECIATION. THE ADMINISTRATION'S LOGIC ON THIS IS PERVERSELY ACCURATE. BUT IT MISSES THE LARGER POINT. THAT IS, IT IS THE HEIGHT OF BAD PUBLIC POLICY TO PROVIDE TAX INCENTIVES TO PROMOTE ECONOMIC GROWTH-- LIKE THE ACCELERATED COST RECOVERY SYSTEM (ACRS)--AND THEN RETROACTIVELY FORCE A PENALTY ON THOSE WHO IN GOOD FAITH PARTICIPATED IN THE ECONOMIC RECOVERY. A SOUNDER APPROACH WOULD BE, IF FOR SOME REASON THE ADMINISTRATION FEELS THERE MAY BE A WINDFALL THROUGH APPLICATION OF A LOWER CORPORATE RATE, TO RECOMMEND A LESS SUBSTANTIAL DROP IN THE CORPORATE TAX RATE.

THE OFFICE BUILDING INDUSTRY IS BECOMING AN INCREASINGLY VITAL PART OF THE UNITED STATES ECONOMY. FOR CITIES OF ALMOST ANY SIZE, OFFICE BUILDINGS NOW REPRESENT THE CORE OF DIRECT AND INDIRECT BUSINESS ACTIVITY. A VIABLE COMMERCIAL REAL ESTATE INDUSTRY WILL ENSURE CONTINUED GROWTH, REVITALIZATION AND A SOUND ECONOMIC BASE FOR OUR CITIES.

WE BELIEVE THAT THE PRESIDENT'S PLAN DESERVES PRAISE FOR FRAMING THE BASIC QUESTIONS. WITH MODIFICATIONS, ADDRESSING THE CONCERNS WE HAVE RAISED HERE TODAY, I BELIEVE OUR MEMBERSHIP WOULD BE WILLING TO SUPPORT A TAX PROPOSAL THAT IS BUILT ON A FOUNDATION OF FAIRNESS AND EQUITY.

The President's Tax Reform Proposal:
Impact on Real Estate

on behalf of the
California Association of REALTORS®
before the Senate Finance Committee

Raymond D. Spinelli, President
July 16, 1985

This testimony is submitted by the California Association of REALTORS® for consideration during the upcoming hearings before the Senate Finance Committee with regard to President Reagan's Tax Reform proposal. The California Association of REALTORS® is a trade organization representing 103,000 real estate licensees in the state of California. Because our business is directly associated with the ability of American families to purchase their own home, we are vitally concerned about any changes to the tax system which would impact on homeownership. The California Association or REALTORS® (the "Association") is pleased to be able to have the opportunity to express our views on the tax reform program recently proposed by President Reagan.

The President's tax reform proposal seeks to make the existing tax code more equitable for all taxpayers and to "neutralize" the tax code so that investments will be made on the basis of economic merit rather than in response to tax considerations. According to proponents,these changes are expected to simplify the tax-paying process for many individuals and to stimulate overall economic growth, objectives that the Association supports. Nevertheless, critics have emphasized the tremendous uncertainty over the impact this far-reaching proposal would have on the U.S. economy and on the federal budget deficit.

The California Association of REALTORS® is supportive of efforts to reform and simplify the present tax system. We acknowledge that there is room for improvement in terms of both the efficiency and equity of the tax system. However, any changes that are adopted must, in our view, provide fair treatment to all sectors of the economy, as well as foster economic growth. In addition, in light of the current status of the federal budget, such a measure should not add to the federal budget deficit.

The Association is also concerned that the Senate has a reasonable understanding of the consequences of any tax changes on the economy. The complexities involved in the far-reaching changes under consideration dictate that, at the very least, these changes be adopted gradually. Specifically, we believe that many of the anticipated disruptive effects of a comprehensive restructuring of the tax system could be avoided or minimized by grandfathering existing activities undertaken prior to the effective date of the legislation. In most instances a far-reaching grandfather clause would be superior to the currently proposed transition rules.

Our key area of concern is the impact of tax reform on homeownership. Under the President's plan, the primary tax incentive for homeownership - the mortgage interest deduction, is retained for a taxpayer's principal residence. However, a number of other proposed changes are likely to directly impact the status of homeownership. Specific areas of concern involve the following provisions:

- The elimination of the deduction for all state and local taxes including property taxes. This proposal would increase taxable income for any of the taxpayers who itemize, particularly in high tax states such as California.

- The elimination of the tax-exempt status of certain state or local government obligations such as Mortgage Revenue Bonds. This will inhibit the supply of housing and worsen the affordability problem. Particularly hard hit will be states like California which extensively use this type of financing.

- The limitation of the personal interest deduction to $5,000 over investment income. This cap on interest deductibility will increase the tax liability of small investors and second homeowners, causing a shift away from investments such as limited partnerships and vacation homes.

- The lowering of marginal tax rates causes a reduction in the value of the mortgage interest deduction in terms of actual dollars saved, increasing the after-tax costs of homeownership.

In addition to homeownership, the concerns of the Association include the proposed changes to the tax treatment of real estate investments. Specifically, these include:

- The elimination of preferential tax treatment for capital gains on the sale of depreciable real property and the reduction of the capital gains exclusion from 60 to 50 percent. Both of these changes will increase taxes at time of sale, thereby reducing after-tax equity and the attractiveness of real estate investments.

- The extension of the "at-risk" rules limitation to real estate. This provision will reduce the attractiveness of tax-oriented limited partnerships and could adversely impact low-income housing in states where limited partnerships have been a chief financing vehicle.

- The replacement of the Accelerated Cost Recovery System (ACRS) with the Capital Cost Recovery System (CCRS) which would increase the write-off period for real estate from 18 to 28 years and permit the depreciation of the inflation-adjusted cost of the depreciable asset. CCRS will reduce the tax savings and lower the internal rate of return of many real estate investments. In the short-run,construction will decline as capital flows into more productive investments.

In order to encourage homeownership and investment in real estate, particularly in low-cost housing developments, C.A.R. strongly urges that the Committee consider the following amendments to the proposal:

- Investment interest - significantly amend provisions to facilitate non-abusive investment in real estate.
- Captial gains - eliminate the proposed differential treatment of depreciable and non-depreciable assets.
- Depreciation - ensure that the depreciation period reflects the useful life of an asset if it is less than the proposed 28 years, and retain the 10-year construction period interest write-off and component depreciation for the useful life of building systems at time of replacement.
- "At-risk" rules - exempt residential real estate investment from these provisions.
- Tax-exempt bonds - maintain the ability to issue tax-exempt Mortgage Revenue Bonds, Mortgage Credit Certificates and Veteran's housing bonds.

Below is a more detailed discussion of the potential impacts of President Reagan's proposals on housing and real estate, as well as the provisions C.A.R. seeks to change in order to maintain the current status of homeownership. The issues fall into two major categories: Impact on Homeownership and Effects on Real Estate Investment.

I. Impact on Homeownership

The deductibility of mortgage interest payments on a taxpayer's primary residence is retained in full under the President's plan. However, the elimination of the current deduction for property taxes, as well as all other state and local taxes, along with the fall in marginal tax rates, significantly reduces the value of the mortgage interest deduction in terms of actual dollars saved. This means that a narrowing of the overall cost advantage of homeownership relative to renting is likely. Given the longstanding commitment of the federal government to homeownership, as evidenced by the fact that the U.S. has the highest rate of homeownership in the world, such a shift could, over the long term, alter the expectations of forthcoming generations of Americans.

An illustration of the impact the tax reform proposals will have on the decision to buy versus rent is shown below in Table 1, where the Federal tax bill owed by a California family of four is calculated using the parameters of the current tax system and the President's proposed system. This hypothetical household consists of two wage earners with a combined income of $35,000, and $5,900 in savings which they are deciding whether to use as a down payment to purchase a home or to invest elsewhere, (assuming a 10 percent annual rate of return). In our example, the home purchased is priced at $85,000 and the mortgage interest rate is assumed to be 13 percent.

Table 1

The Buy vs Rent Decision:
Current Tax System
and the
President's Proposed Tax System

	Purchase Home		Rent	
	Current System	Reagan's Plan	Current System	Reagan's Plan
Income	$35,000	$35,000	$35,000	$35,000
Taxable Dividend Income	-0-	-0-	590	590
Taxable Health Insurance	-0-	300	-0-	300
Two-Earner Deduction	949	-0-	949	-0-
Adjusted Gross Income	34,051	35,300	34,641	35,290
Itemized Deductions **Mortgage Interest**	10,000	10,000	-0-	-0-
Other Personal Interest	2,000	2,000	2,000	2,000
Property Taxes	850	-0-	-0-	-0-
Other State and local taxes	400	-0-	1,000	-0-
Total Itemized Deductions	13,250	12,000	3,000	2,000
Zero Bracket Amount	3,400	4,000	3,400	4,000
Total Deductions	9,850	8,000	-0-	-0-
Personal exemption	4,320	8,000	4,320	8,000
Taxable Income	19,881	19,300	30,321	27,290
Federal Tax Due	2,440	2,295	4,908	3,494
Disposable Income	$32,560	$32,705	$30,682	$32,096

Under the current tax system homeownership is heavily favored. A federal income tax bill of $2,440 if a home is purchased versus a tax bill of $4,908, more than double, if they decide to rent. Under the President's tax program, the family deciding to buy a home would have fewer itemized deductions because of the elimination of state and local tax deductions, including property taxes. The effect is somewhat offset by the increase in the zero bracket amount to $4,000 and the almost doubling of the personal exemption to $2,000 per family member. The Federal tax bill under the President's plan would then be $2,295, versus $3,494 for the family deciding to rent, which is only 52 percent more than the family deciding to purchase.

The comparision of the buy vs. rent scenarios demonstrates that with the proposed tax changes, the homeownership alternative is not as attractive from a tax perspective as under the current system. While the tax bill for the homeowner is still less under the proposed system than the renter's tax liability, the difference in disposable income between the two alternatives has been narrowed, thereby reducing the incentive to purchase. Our results also show that although after-tax housing costs are greater under the President's proposal, there is little change in the burden of buying a house between the two tax systems because of the increase in disposable income resulting under the President's plan.

Against this background, a number of conclusions can be drawn. Our analysis shows that if the President's tax reform proposal is adopted, the incentive to purchase has been reduced because the tax benefits to homeowners relative to renters is less. The implications for resale transactions volumes or on housing prices are, however, uncertain. Much of the demand for single-family homes has not been driven by tax preferences to the extent found in certain real estate tax shelters. The reduction in the tax benefit differential between buyers and renters, therefore, would not be expected to negatively affect home volumes for primary residences. The expected increase in after-tax income under the President's proposal may be less or even negative for an important segment of the housing market, first-time buyers. The results of the most recent C.A.R. Housing Finance Survey indicate that, compared to repeat buyers, first-time buyers have less income, are more likely to have two wage earners in the family and have fewer children. The reduction in tax rates, the elimination of the two earner deduction, and the increase in the personal exemption will tend to be less beneficial to first-time buyers, resulting in a smaller reduction in their overall tax bill.

A shift in the composition of sales rather than a change in the volume of resale transactions volume is likely. Existing homeowners, particularly those in the upper income bracket, may trade up to more expensive housing because the $5,000 cap on personal interest deductions in excess of investment income leaves only the purchase of a more expensive home as a avenue to deduct interest through homeownership. In California, the market will be impacted most strongly in the high cost coastal regions of the state. This shift will be moderated to extent that the decline in the top marginal rate from 50 percent to 35 percent reduces the incentive to shelter.

C.A.R. Recommendation on State and Local Taxes:
In order to maintain the incentive towards homeownership implied in our tax system, C.A.R. recommends that deductibility of state and local taxes, including property taxes, be retained, or that partial deductibility be secured. Possible options for permitting state and local tax deductibility while maintaing some of the revenue the Federal government would realize, would be to allow deductibility at only the lowest marginal tax rate (15 percent) or capping deductibility as a percentage of federal tax liability.

Impact on Second Homes

Under the President's program, the limitation on the investment interest deduction is expanded to include all personal interest, other than mortgage interest on the taxpayer's principal residence, and is limited to $5,000 plus passive investment income earned during the year. Any interest expenses in excess of this limit are not deductible, including interest paid on second home purchases. The limitation on deductible interest would be phased-in under two rules. First, for the two-year period from January 1, 1986 through January 1, 1988, the interest limitation remains at the current $10,000 plus net investment income. After Janaury 1, 1988 the $5,000 limit takes effect. Under the second phase-in rule, after January 1, 1986 an increasing percentage of interest expense that is treated as investment interest under the expanded definition but that is not subject to the investment interest limitation of current law (including interest on second homes), would become subject to the proposed expanded investment limitation.

This obviously reduces the incentive to purchase a second home, especially for those individuals with no investment income and no other interest expenses. In such a case this rule would provide for a full deduction only for vacation home mortgages of less than $40,000 at prevailing rates or about $417 a month. Any interest above that amount would not be deducted. Obviously, certain markets that depend heavily on the vacation/resort home sales will be severely impacted by reduced demand and subsequently falling home values. In California, for example, sales in the Palm Springs/Palm Desert area would be dampened because the great majority of units purchased in the area are second homes. Overall, it would appear that it is the middle income purchasers of second homes, those without significant interest or dividend income, that would be the most effected by the change.

C.A.R. Recommendation on Investment Limitation:

In order to avoid penalizing the smaller investor and second home owner, C.A.R. seeks to amend this limitation while retaining the President's goal to eliminate the practice of some tax payers of using the substantial tax shelter for interest expense to off-set business and employment income. One possible change to the limitation might be to amend the definition of "net investment income" to include other sources of income in addition to "passive investment income". Another possible change might be to permit investment interest to be deducted at a relative lower marginal tax rate. This we believe, would address the abusive situations without significantly impacting smaller investors and second homeowners.

Impact on Mortgage Credit Availability

The President has proposed to eliminate the tax-exempt status of any obligation issued by a state or local government if more than one percent of the proceeds are used directly or indirectly by any entity other than the state or local government. This would include Industrial Development Bonds, Veteran's Mortgage Bonds, Mortgage Revenue Bonds (MRBs), and the recently authorized Mortgage Credit Certificate program. In California, Mortgage Revenue Bond financing has been used extensively. Mortgage Revenue Bonds issued increased from $1.6B in fiscal 1977-78 to $2.8 billion issued in fiscal 1982-83. In fact, in the 8 year period ending June 1984, the California Housing Finance Agency provided financing for 15,125 owner-occupied units statewide. In addition, many local governments have issued tax-exempt Mortgage Revenue Bonds on their own. By offering mortgage financing at 200 or even more basis points below market rates, tax-exempt Mortgage Revenue Bonds are able to assist low and moderate income persons in obtaining affordable housing and to increase the supply of housing by increasing the amount of capital available to support the construction and purchase of housing.

According to a report by the legislative analyst, several studies suggest that the net addition to the housing stock from the use of MRBs is equal to approximately 20 percent of the amount raised by the issuance of these bonds. Thus, the repeal of private purpose tax-exempt bonds issued by state and local governments can significantly worsen the affordability problems in California by putting homeownership out of reach for many residents.

It would also have a drastic effect on moderate income rental housing development. In 1983, tax-exempt bonds issued in the United States financed $5.3 billion worth of apartment buildings. Additionally, the elimination of Mortgage Credit Certificates which are tied to the MRB program would shut off an instrument that has the potential of significantly increasing the use of this preferential financing for first-time buyers in the re-sale market. Until now, MRBs have almost exclusively served the new housing market. Thus, although the loss of tax-exempt bonding authority would be more significant for the new home market in a short term, over the longer turn, the impact could be nearly as significant in the resale market.

C.A.R. Recommendation on Tax-Exempt Bonds:

C.A.R. seeks to retain the current treatment for tax-exempt Mortgage Revenue Bonds and Veteran's bond, including the recently authorized mortgage credit certificates. We believe these programs are important in assisting first-time homebuyers, and low and moderate income renters, and thus should be retained in any final tax reform plan.

II. Impact on Real Estate Investment

The President's proposal replaces the accelerated cost recovery system (ACRS) with the capital cost recovery system (CCRS), and eliminates the preferential tax treatment for capital gains on the sale of depreciable real property. Under the current tax system the recovery period for depreciable real property is 18 years and 60 percent of capital gain upon sale is excluded from taxation. Under the President's plan, the recovery period would be increased to 28 years and all gains on the sale of depreciable assets would be taxed as ordinary income. In addition, depreciation is calculated on the inflation adjusted basis as opposed to original cost. Non-depreciable property, such as land, is still eligible for preferential capital gains treatment, but under the President's plan, the exclusion rate would be reduced from 60 percent to 50 percent. However, the reduction in the maximum tax rate from 50 percent to 35 percent results in the lowering of the maximum capital gains rate from 20 percent to 17.5 percent.

In order to measure the impact these changes would have on real estate investment, we have analyzed a specific investment under the parameters of the current tax system and then looked at the same example under the President's proposed tax system. In our example, an investor is considering the purchase of a $1 million apartment complex which she anticipates holding for ten years. Seventy percent of the selling price covers the existing building, while 30 percent represents the value of the land on which the structure is situated. Rents during the first year are expected to total $150,000 and to increase 7 percent every year for the full 10 year holding period. Operating expenses during the first year will be $75,000, and are anticipated to increase by 5 percent every year. The investor puts down $200,000 in cash and finances the remaining $800,000 with a 30 year fixed-rate mortgage loan at 12 percent. Inflation is expected to increase at an annual rate of 5 percent per annum throughout the 10 year period. In line with this assumption, the investor anticipates being able to sell the property at the end of 10 years for a selling price of $1,500,000.

Assuming that the investor is in the 50 percent marginal tax bracket, we calculated the tax liability under the current system for the ten year holding period. We then calculated the return to the investor at the time of sale, taking into account capital gains and depreciation recapture. The total gain from the sale will be $846,854. Under current tax law, only 40 percent of this gain is taxable, resulting in a capital gain tax liability of $169,371. In addition, the amount by which allowable depreciation under ACRS exceeds the straight line method ("excess depreciation") is taxed as ordinary income. Total taxes due at time of sale are $190,535 leaving the investor with after-tax equity of $562,143. The internal rate of return of the investment, the rate which equates the present value of the cash inflows with the present value of the cash outflows, is 18 percent.

TABLE 2

Summary of Impacts on Real Estate Investment

	Current System	Proposed System	Percentage Change
Capital gain on sale	$846,854	$813,996	- 3.9%
Capital Gain Tax	$169,371	$258,649	52.7%
Tax on Excess Depreciation	$ 21,164	-0-	-0-
After-Tax Equity	$562,143	$494,029	-12.1%
Internal Rate of Return	18.0%	14.2%	-21.1%

If the President's proposed changes were adopted, the results of the analysis would be significantly altered, as shown in Table 2. In general terms, the amount of unrelated income sheltered from taxation is lower, taxes due are higher, equity after sale is lower, and the internal rate of return of the project has been reduced by 21 percent. As a result of the lower values for allowable depreciation under CCRS and the reduction in the maximum marginal tax rate from 50 percent to 35 percent, taxable income and tax savings in the first five years of the investment are reduced under the proposed system.

Taxes due at the time of sale will increase from $190,535 under the current tax system to $258,649 under the proposed system. As a result of the reduction in the total amount of depreciation claimed over the ten years, and therefore the higher tax liability, after-tax equity is reduced from $562,143 to $494,029. The internal rate of return on the investment is calculated to be 14.2 percent, a 21 percent decline from the internal rate of return under the current tax code.

Effect on Rents

If the proposed changes were to be adopted it is anticipated that investors would attempt to increase rents in order to make up for the decline in return. In our example, rents would have to increase by ten percent in order to maintain the 18 percent rate of return achievable under the current tax system. The effect of such an increase in rents could be devastating for renters. Additionally, in high cost areas the projected increase in rents could equal or easily exceed any tax savings for renters from the switch to the President's system. Rent increases would be particularly devastating for low income households. A study recently completed by the General Accounting Office found that both the number and the percentage of lower income households (earning less than 80 percent of area median income) with rent burdens (rent divided by gross income) in excess of 30 percent, increased by about 4.1 million between 1975 and 1983. By 1983 the total number of households in this category had increase by 11.9 million or about 64 percent. The most significant deterioration occurred among households with very low incomes, less than 50 percent of area median. These considerations make it imperative that mitigating measures are available to counter anticipated pressures to raise rents if the proposed tax program is enacted.

It is unlikely that rents will increase significantly in the early years after enactment of the proposed tax plan in direct response to the program. It will take time for the anticipated reduction in the flow of capital into real estate to translate into a decline in the rate of new construction. It is only when there is an excess demand for the existing stock of the available space that rents will be pushed upward. However, rents will be impacted more quickly in areas where vacancy rates are already low. In the large coastal cities of California, vacancy rates currently range from 0.5 percent in San Francisco to 2.5 percent in San Diego compared with national averages in the range of 5 to 7 percent. In addition, we can say that as long as rents are held down by excess supply, as is currently true for commercial buildings in many areas in the United States, the adjustment to the reduced profitability of investment due to changes in the tax code will be felt instead in pressures for falling prices.

It is also likely that California will be more adversely affected than other areas of the country by the proposed tax changes. This is because real estate investment in the state typically yields negative cash flows during the early years of the investment unlike other parts of the country. Prices that may be as much as 50 percent higher in California than elswhere, and the prevalence of the rent controls which artificially restrict rent adjustments, are two of the major factors that limit the early period cash flows. During this time the ability to deduct many of the expenses associated with the investment, coupled with high marginal tax rates, result in tax savings for the investor and, in a sense, justify the investment. Reduction in the appreciation deduction under CCRS, the limitation on losses by the extension of the "at-risk" rules to real estate, and the reduction in the marginal tax rate are all changes that will reduce the return in California relative to other parts of the country and will increase the holding period required for recovery of the investment.

C.A.R. Recommendation on Depreciation:

The proposed capital cost recovery system (CCRS) which will lengthen the write-off period for real property investment to 28 years, is generally acceptable. C.A.R. does, however, seek to retain the construction period interest write-off at the current ten years and to permit component depreciation for the useful life of building systems at the time of replacement. If these technical corrections cannot be achieved, then a shorter period for cost recovery on real estate investment is strongly urged.

C.A.R. Recommendation on Capital Gain:

C.A.R. seeks to eliminate the differential treatment of depreciable assets in such a way as to maintain the estimated revenue gain of the President's proposed revision. Potential means of addressing this issue include a lower exclusion rate from the 50 percent proposed for imputing capital gains. In this manner, C.A.R. hopes to maintain the attractiveness of real estate relative to alternative investments.

"At-risk" Rules

Under the current tax system, investors can deduct amounts in excess of their actual investment in a project, because depreciation and other expenses are based on total value, not simply the amount of cash invested. The "at-risk" rule limits tax deductions to the amount of cash actually invested. The President has proposed to apply these rules to real estate for the first time. The extension of the "at-risk" rules to real estate will reduce the attractiveness of tax oriented limited partnerships. Limited partnerships have been a chief vehicle for financing low/moderate income housing because these are usually low yielding investments. The effect of this change, therefore may be to adversely impact low income housing.

C.A.R. Recommendation on "At-risk rules:

In order not to penalize small investors and to prevent any worsening of current rental housing shortages, C.A.R. seeks to exempt residential real estate investment from the proposed extension of "at-risk" rules to real estate. C.A.R. believes that the application of "at-risk" rules to real estate would substantially decrease the amount of investment in residential real estate and exacerbate currant rental housing shortages. By no longer permitting any type of investor to deduct losses in excess of amounts actually at-risk, including debts affected by anti-deficiency legislation, these provisions would penalize small investors. Further, there are other proposed changes in the treatment of investment real estate ownership which would minimize any abuses in this area.

III. Conclusions:

The Association supports the efforts being undertaken by the Senate to ensure that any tax reform measure being considered will be fully evaluated. We can not stress strongly enough the necessity of analyzing these provisions, individually and as a group, for their overall impact on the economy as a whole, as well as the differential impact on different sectors within the economy. Specifically, given its mandate to encourage homeownership, the Senate must ensure that any changes to the tax code does not reverse this long-standing priority. In addition to homeownership, the effect the proposed changes would have on real estate investments are of vital concern. As discussed earlier, in its current form, the President's proposal will generate upward pressures on rents, reduce the supply of residential construction and significantly reduce the flow of capital into real estate. Low-income housing, the beneficiary of many existing tax-related subsidies, will be perhaps the most severely impacted. Finally, because of the real effect the uncertainty surrounding tax reform legislation has already generated in the market, we urge the Committee to consider a meaningful grandfather clause to insulate the market from unnecessary disruption. We thank you for the opportunity to express our views on this crucial issue.

Sincerely,

Raymond D. Spinelli
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STATEMENT
of the
COALITION FOR LOW AND MODERATE INCOME HOUSING
submitted to the
COMMITTEE ON FINANCE
UNITED STATES SENATE
in connection with hearing on
July 16, 1985
regarding Housing, Real Estate and Rehabilitation

I. Background

The Coalition for Low and Moderate Income Housing brings together in a single coalition all associations, trade groups, business organizations, and individuals, as well as associated professionals, involved in the private financing, production, rehabilitation and operation of government assisted low and moderate income multi-family rental housing. The Coalition works with the Administration, Congress, state governments and others in an effort to promote the financing, production, rehabilitation and operation through private enterprise of low and moderate income housing in the most effective way possible. It is constantly seeking new and better methods for accomplishing that objective.

II. General Discussion

Among the proposed changes in the tax law set forth by President Reagan and being considered by this Committee are proposals which would cripple the production, rehabilitation and preservation of low and moderate income housing. If this Committee and the Congress enact these proposals, the Coalition strongly believes that exemptions should be provided for low and moderate income housing, for the reasons stated below.

For over two decades, Congress has attempted to subsidize the production and operation of low and moderate income housing in a variety of ways, but all of the subsidies have taken two basic courses: (1) direct subsidies, such as the HUD Section 236 Program, the HUD Section 8 Program, the Section 515 Farmers Home Administration, and similar state and local programs; and (2) indirect subsidies, primarily through incentives contained in the federal income tax law.

Although direct subsidies are provided, under federal, and most state, housing assistance programs the rents that may be charged are limited and the cash flow from the project that may be distributed is low. Moreover, restrictions on use of the properties for anything other than low income housing generally extend for a decade or more, reducing or eliminating market appreciation. In the absence of tax incentives, these are strong disincentives to invest in low and moderate income housing.

Moreover, in recent years, substantially all of the direct subsidies have been phased out by this Administration and by Congress. The only meaningful subsidies remaining are those provided through the Internal Revenue Code.

Even before Congress enacted the Economic Recovery Tax Act of 1981, it recognized that an adequate supply of housing, and other productive real estate, is created only by private investment. For over 15 years Congress has enacted or retained specific tax incentives to encourage private investment in real estate, particularly in housing -- an investment which creates new jobs, revitalizes urban areas, and provides shelter at a fair price for millions of Americans. Were it not for these tax incentives enacted by Congress, it is highly unlikely that there would be any production of low and moderate income housing today.

Real estate investments normally are economic only if the investors can take advantage of the tax incentives enacted by Congress, including deductions for accelerated depreciation and interest on indebtedness. Accordingly, such investments are generally made through limited partnerships so that these incentives can flow through to individual investors. Typically, the rents and other items of current income from a real estate investment are exceeded by the expenses of the investment, including debt service.

Because of the high cost of constructing or rehabilitating low and moderate income housing properties, investments in such real estate are generally feasible only through the incurrence of substantial indebtedness. When a partnership is the investment vehicle, the indebtedness is typically nonrecourse, i.e., it is secured only by the property itself and the limited partners are not personally liable on the debt.

The combination of deductions for accelerated depreciation and interest, plus availability of nonrecourse indebtedness, have made investments in low and moderate income housing attractive. However, certain of the proposals contained in the President's plan for tax reform would virtually eliminate the incentives to invest in low and moderate income housing.

III. Specific Proposals

A. Extension of At-Risk Rules to Real Estate

Under current law, real estate activities are exempted from the at-risk rules. The President's proposal would extend the at-risk rules to all real estate activities. A taxpayer investing in real estate could only deduct losses in an amount equal to the money or property directly "at-risk" in the investment. The President's proposal states that this "would not inhibit the leveraged acquisition of properties expected to yield a market rate of return." (President's proposal at p. 326) As discussed above, investments in low-income housing will rarely yield a market rate of return. Accordingly, if the at-risk rules are extended to all real estate, an investment in low and moderate income housing will not be able to compete in the market, and dollars which would, under current law, be directed to the development of low and moderate income housing will go elsewhere.

The President's proposal suggests that the purpose of the at-risk rules may be to restrict the opportunities for artificially inflating the value of property through the use of nonrecourse seller financing, yielding inflated tax benefits, rather than restricting the losses that taxpayers can take. Accordingly, the proposal suggests exempting from the at-risk rules unrelated third-party financing from institutional lenders, thus focusing the at-risk rules solely on abusive transactions.

Recommendation. The Coalition supports such an approach and recommends that, if the proposal to extend the at-risk rules is adopted, an exception be made for all rental housing financed with debt from unrelated third-party institutional lenders such as banks, insurance companies, and federal, state and local agencies. In addition, with respect to existing low income housing, an exception should be made for seller financing, the terms of which are controlled by, or require the approval of, HUD or the appropriate state housing agency. We believe that such exceptions will prevent abusive transactions while permitting investment in low and moderate income housing to continue.

B. Investment Interest

Under current law, interest expense incurred by a limited partnership is generally fully deductible by the investor limited partners. The President's proposal would expand the current definition of investment interest subject to limitations on deductibility to all interest expense incurred by a limited partnership and passed through to the limited partners. General partners would not be subject to this restriction. In addition, the limitations on the amount of investment interest that could be deducted each year would be reduced from $10,000 to $5,000.

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Excess interest could be deducted only in the current tax year to the extent of net investment income. These proposals would be phased-in over several years.

One of the primary incentives for taxpayers to invest in low and moderate income housing under current law is the deductibility of interest expense. Low and moderate income housing generally does not generate substantial amounts of net income, because of restrictions on rentals and on rates of return, in contrast to non-low and moderate income rental properties or commercial properties. Because of these restrictions, low and moderate income properties do not generate quantities of net income which could be used to affect excess interest and under the President's proposal, low and moderate income housing would be unfairly disadvantaged.

Recommendations. In order to make an investment in low and moderate income housing a realistic alternative to investment in some other property, the Coalition recommends that, if the President's proposal is adopted, an exception should be made for investments in low and moderate income properties. In addition, the Coalition recommends that an exception be provided for interest incurred on all new rental housing for a period of ten years from the time such housing is placed in service. New rental housing generally does not generate substantial amounts of net investment income in the first ten years of operation which could be used to offset investment interest in excess of the limitations, and it should not be unfairly disadvantaged as compared to existing rental or commercial property.

C. Depreciation

Under current law, low income housing is depreciated over 15 years using the 200% declining balance method. The President's proposal would extend the depreciation period to almost twice that under current law, to 28 years, at a rate of 4% per year, with adjustments for current inflation and prior depreciation.

Accelerated depreciation is one of the primary tax incentives for investing in low and moderate income housing. Congress recognized this as recently as one year ago when the depreciation period for all real estate except low income housing was stretched to 18 years. Without this incentive, and by lumping all real estate into the same depreciation period, low and moderate income housing projects will simply not be able to compete in the marketplace for investors. And, without investors, there will be no new or rehabilitated low and moderate income housing projects.

Recommendation. The Coalition strongly recommends that the depreciation period for low income housing be retained at 15 years, along with the current method of depreciation. In addition, if the President's proposal is adopted, the depreciation period for other real estate should be shortened to something less than 28 years. We would be happy to work with the Finance Committee and Committee staff on developing an appropriate standard.

D. Definition of Low Income Housing

The current definition of low income housing in Sections 1250 and 1039 of the Code have been in the Code for years and should be amended to reflect the changes in the low income housing industry. Moreover, the current definitions are vague in parts, leading to disputes between taxpayers and the Internal Revenue Service on what constitutes low income housing.

Recommendation. We would appreciate the opportunity to work with the Committee on developing a better definition, either in conjunction with the President's proposals or in connection with some other piece of legislation.

E. Transition Rules

With some exceptions, most of the provisions of the President's proposal will take effect, if enacted as currently drafted, for property placed in service or expenditures incurred on or after January 1, 1986.

The proposal states that the option to provide for transition and "grandfather" rules should be left to Congress. The proposed January 1 effective date, without transition rules, has already had an impact on the real estate industry. Developers currently building or rehabilitating property that will not be completed by year end face the prospect of having made their plans to develop the property under one set of tax rules with the possibility of placing it in service under another. In some instances, projects consisting of more than one structure will have to be segregated for treatment under different tax rules, creating tremendous allocation headaches.

Recommendation. We strongly urge the Finance Committee to provide for exemptions for property either under construction, or subject to a binding contract to acquire or construct, similar to those recent in tax legislation.

F. Other Low Income Housing Issues

The President's proposal contains several other provisions that, if enacted, will have on adverse impact on the development of low and moderate income housing.

1. Section 167(k). The President's proposal would repeal Section 167(k). This provision, which under current law permits a five-year amortization of expenses incurred to rehabilitate low income housing, is an additional tax incentive

favoring the rehabilitation of low income housing projects. Its repeal would have an adverse impact on the ability to compete in the marketplace with other non-low income housing investments.

2. Section 189. Under current law, interest on debt incurred to construct low income housing is currently deductible. The President's proposal would require capitalization in most cases. The stated purpose of this proposal is to more closely match deductions and income. Low income housing projects generally do not generate very much income in any year, so that the preceived abuse in permitting current deductions of interest expense does not exist. Moreover, as with other provisions in the President's proposal, this will result in investments in low income housing becoming less attractive.

Recommendation. Retain the provisions of current law for both Section 167(k) and Section 189.

IV. Other Matters Affecting Real Estate

The President's proposal also contains provisions that do not have a direct impact on low and moderate income housing but that will have a direct adverse impact on real estate in general.

1. Bonds. The President's proposal would provide that interest on obligations issued by state and local governments would be taxable if more than 1% of the proceeds are used by any person other than a state or local government. This proposal would eliminate the tax exempt status of multi-family and single family housing bonds. To make these bonds competitive with taxable bonds will require providing a higher yield on the bonds, thus making it more expensive to build housing.

Recommendation. The Coalition recommends that this provision not be enacted or, if enacted, provide an exception for housing bonds.

2. Windfall Depreciation Recapture. The President's proposal would seek to "recapture," and tax, in years 1986, 1987 and 1988 "excess depreciation" taken in prior years, generally measured by the excess of depreciation taken over the depreciation set forth in the original Treasury proposal. This excess depreciation would be taxed whether or not the property was disposed of. Taxpayers with depreciation over $400,000 would be subject to this provision. While this proposal is unlikely to have an impact on many of the businesses and individuals represented by the Coalition, the Coalition believes that it is basically unfair because it would penalize taxpayers who have depreciated their property in accordance with the rules established by Congress, and because it would impose taxes on taxpayers who may not have realized any income.

Recommendation. This provision should not be enacted.

3. Rehabilition Tax Credits. The President's proposal would repeal all existing rehabilitation tax credits. Under current law, the 25% credit for expenditures incurred to rehabilitate historic structures can be used for multi-family housing renovation. It has been used to renovate historic buildings in urban areas to provide much-needed housing, and is a very attractive incentive to invest in such renovations.

Recommendation. The Coalition recommends that the rehabilitation credits be retained.

4. Capital Gains. The President's proposal provides that depreciable property would not be classified as a capital asset, so that all gain on sale or disposition would be fully taxed at ordinary income rates. The proposal indicates that since depreciable property benefits from other tax incentives, i.e. depreciation, that it should not receive additional benefits in the form of capital gain treatment.

Recommendation. The Coalition does not accept the proposition that capital asset treatment should be granted or denied simply because of the availability of other tax benefits, and recommends that this provision not be enacted.

Conclusion

In summary, the Coalition for Low and Moderate Income Housing believes that the present tax incentives directed at the maintenance and rehabilitation of multi-family rental housing for individuals and families of low and moderate income are vital to that process and, indeed, are the only such incentives left, now that most direct subsidies have been eliminated. These tax incentives not only do the job, but, in the long run, the economic benefits of them accrue to the renters, and preserve our nation's diminishing housing stock.

COMMENTS BY BIAGIO DILIETO, MAYOR OF THE CITY OF NEW HAVEN, CONNECTICUT, PREPARED FOR THE SENATE FINANCE COMMITTEE, JULY 15, 1985.

On behalf of the City of New Haven, I am writing to oppose the Treasury Department's amended Tax Reform Plan which is before the U. S. Congress for consideration. This proposed Plan would repeal all Investment Tax Credits for the rehabilitation of older and historic structures and, if passed, would have a devastating impact on aging cities such as New Haven.

Although New Haven, Connecticut, is the seventh poorest City in the United States according to Bureau of Census figures, it is rich in older and historic buildings. Because of the 15%, 20% and the 25% Investment Tax Credits, many of our structures have undergone extensive restoration, both in downtown and in the neighborhoods. Additional projects are contemplated or were under consideration until emergence of the Tax Reform Plan. An example is a major project at the center of our City, known as the Ninth Square, which could virtually come to a halt if the Tax Reform Plan is passed.

"Ninth Square" is a contemporary term for a 30-acre area in New Haven's downtown which is roughly synonomous with one of the original nine squares laid out in 1638 by the Puritan founders of New Haven. Since World War II, suffering as it did the general decline of older central cities, the Ninth Square experienced economic and physical deterioration. Much of the floor area in its buildings is now vacant or under-utilized.

In 1982, in recognition of the value of the National Register program leading to Investment Tax Credits, the City of New Haven submitted a pre-selection application to the State Historic Preservation Office and, upon its approval, the New Haven Preservation Trust prepared a nomination study which placed the Ninth Square on the National Register of Historic Places. As a result, 75 of the 90 buildings in the district would be likely to qualify for the 25% Historic Tax Credit. The City's Development Administration has witnessed an impressive growth in investor interest in the Ninth Square, largely because of its historic district status. The Plan before you would nullify current efforts to revitalize this neglected part of our downtown.

In recent years, our City has begun to experience an economic resurgence. In the downtown, the Shubert Square Entertainment District, of which we are so proud, could not have been accomplished without the incentive of Investment Tax Credits. Our neighborhoods have also benefitted from this legislation and would suffer harm if the amended Tax Reform Plan becomes a reality. Under current tax law, the 15% and 20% Investment Tax Credits have enabled developers to return to active use older buildings which served as pockets of neighborhood blight prior to rehabilitation.

Without the 15% and 20% Investment Tax Credits, this life-giving activity in neighborhoods would cease.

I cannot urge you strongly enough to defeat the Treasury Department's amended Tax Reform Plan and to retain Investment Tax Credits for rehabilitation of older and historic properties. The Tax Reform Plan would harm those cities that can least afford it, i.e., older, poorer municipalities with large minority populations. Our economic recovery is fragile. We need the Investment Tax Credits, and we thank you for voting to preserve them.

equity programs investment corporation

STATEMENT OF
EQUITY PROGRAMS INVESTMENT CORPORATION
TO THE SENATE FINANCE COMMITTEE
ON THE IMPACT OF
THE PRESIDENT'S TAX PROPOSALS
ON THE
RENTAL OF SINGLE-FAMILY HOMES

JULY 16, 1985

- Since the late 1970's high mortgage rates have precluded the purchase of single-family homes by a significant number of would-be first-time buyers.

- Aspects of the Economic Recovery Tax Act ("ERTA") of 1981 encouraged the purchase by investor-partnerships of single-family homes for rental to families that could not afford the high purchase prices or mortgage rates.

- Equity Programs Investment Corporation ("EPIC"), headquartered in Falls Church, Virginia, currently manages 350 investment partnerships that own 18,000 single-family homes nationwide.

  - average purchase price - $78,000
  - average family size of renting families - 2.6

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a member of the epic group

- average annual income - $30,000
- average monthly rent - $529*

o EPIC's single-family home investments typically are organized as limited partnerships. This permits:

- geographically diverse portfolios of homes
- negotiation of low home purchase prices
- professional management

o The President's Tax Proposals would undermine seriously returns to investors on investments in single-family home partnerships. The following proposals affect investor-partners' returns most significantly:

- the expansion of the investment interest limitation to include a limited partner's share of the interest expense of limited partnerships
- the reduction in the rate at which single-family rental homes can be depreciated
- the elimination of capital gain treatment on the disposition of single-family rental homes

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* All figures closely parallel those of an average young American family.

- Few EPIC investors have a significant amount of investment income. After the phase-in of the expanded investment interest limitation, the current return on single-family home limited partnership investments would be reduced by as much as 75%.

- The limit on deductibility of single-family home limited partnership mortgage interest is inconsistent with a key concept of the President's proposals -- 100% deductibility of mortgage interest incurred by homeowners. Such limit also is unfair. Investors having investment income from bonds, inheritances, etc. would not be affected by the limit. It only would affect wage-earners.

- The combination of the changed depreciation schedule for real estate under CCRS and the elimination of capital gains treatment on the disposition of single-family rental homes would reduce the overall rate of return on single-family rental home investments by 60%.

- To restore the reduced rate of return on single-family rental home investments would require an increase in rental rates of 25%. Inability to raise rents by that factor would lead to a serious decline in new single-family rental home construction, exacerbating the housing shortage.

- The acceleration of the depreciation schedules for equipment under CCRS combined with a deceleration in the CCRS depreciation rate for single-family homes "unlevels" the investment "playing field." This is unfair; it will encourage investment dollars which would have flowed into real estate, including single-family rental homes, to be invested in equipment.

- To the extent equipment purchased is of foreign manufacture, American construction jobs would be exported to foreign factories thereby increasing domestic unemployment and reducing tax receipts at the federal and local levels. Such a policy promotes neither growth nor revenue neutrality.

epic

equity programs investment corporation

IMPACT OF THE PRESIDENT'S TAX PROPOSALS ON MIDDLE-CLASS HOME RENTERS

Since the late 1970's, high home mortgage rates have shut a significant portion of would-be first-time home buyers out of the single-family home purchase market. Millions of young, growing American families have been forced to remain in cramped apartments, denied the benefits of single-family home living enjoyed by their predecessors in the 50's, 60's and early 70's.

In late 1981, however, the Economic Recovery Tax Act ("ERTA") was enacted. Certain aspects of ERTA operated to provide a mechanism by which large numbers of young Americans could begin to raise their families in single-family homes. ERTA encouraged the purchase by investors of single-family homes and the rental of those homes to families who could not afford inflated purchase prices and high mortgage payments.

Until ERTA, few new single-family homes were bought as investment properties and rented out. Single-family home investment returns simply had been too low to attract investment capital. ERTA allowed investors to earn returns on single-family home investments which were competitive with more traditional real estate investments and other property-leasing (e.g., computer equipment) investments.

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Most single-family home investments have been organized as limited partnerships. This format allows investors to (1) combine their investments into geographically diversified portfolios of homes for protection against the vagaries of individual markets, (2) negotiate lower home purchase prices and (3) be able to afford professional management of rental homes.

Foremost among the companies organizing and managing single-family home investment partnerships is Equity Programs Investment Corporation ("EPIC"), headquartered in Falls Church, Virginia. EPIC and its affiliated companies currently manage over 350 investment partnerships which own over 18,000 single-family homes nationwide. All of these homes are new, and approximately 90% of them are leased to residential tenants. (The other 10% are on 1-2 year leases as builder model homes.)

The average purchase price of the single-family homes owned by the EPIC investment partnerships is $77,608. This figure is close to the national median price of new housing. The average size of the families renting EPIC partnership homes is 2.6 people. The average annual income of the families renting EPIC partnership homes is $30,000; the average monthly rent paid to the investment partnerships by renter families is $529. These figures closely parallel the profile of the average young American family.

The cited statistics demonstrate that single-family home partnerships such as those organized and managed by EPIC provide the type of housing needed by a significant segment of the American public.

Because they would undermine seriously the returns investors could earn on investments in single-family home partnerships, several of the proposals contained in the President's tax plan could end the formation of new single-family home rental partnerships thereby reducing the availability of single-family rental homes and increasing the rental costs of existing single-family rental property. These proposals include: 1) expansion of the investment interest limitation (Chapter 13.01 of the President's proposals); 2) elimination of capital gain treatment on the disposition of single-family homes (see Chapter 7.03 of the President's proposals); and 3) reduction in the rate of depreciation of single-family homes (see Chapter 7.01 of the President's proposals).

The President proposes to limit to $5,000 a limited partner-investor's deduction for his share of the mortgage interest incurred by the partnership unless that investor had unearned income. To the extent the limited partner-investor incurred consumer interest expenses, such as interest on car payments, credit card payments, home improvement loan payments and student loan payments, the $5,000 limit would be reduced further. The financial profiles of the overwhelming majority of investor limited partners in EPIC single-family investment partnerships indicate that few investors have significant amounts of unearned income. Most EPIC single-family investment limited partnership investors are salaried employees, professionals or executives in small business. The bulk of their incomes (which average approximately $70,000 per year) is derived from work rather than inheritances or investments. The proposed investment interest deduction limitation would eliminate the major element of these investor partners' current return on their single-family home partnership investments.

Without the ability to deduct all of the mortgage interest incurred by the single-family home partnerships, the current return to the majority of investor limited partners would be cut by more than 75%. These partners, therefore, would have no incentive to invest in single-family home rental partnerships. As a result, fewer single-family rental homes would be built, the rents on ones already constructed would increase, and the young families already prevented by high mortgage rates and inflated prices from purchasing single-family homes also would be shut out from renting them.

The limitation on the deductibility of single-family home limited partnership mortgage interest is completely inconsistent with a key element of the President's proposals -- preservation of the deductibility of 100% of the mortgage interest paid by homeowners. If home prices were lower and interest rates were at more traditional levels, most families renting single-family partnership homes would own them. As owners, they would be entitled under the Treasury proposal to deduct their mortgage interest. Because single-family limited partnerships merely permit families to live in the homes they otherwise would own and because overall mortgage interest deductions are not increased (because the same number of homes would exist), the limited partners providing these homes should be permitted to deduct the mortgage interest paid to finance their single-family rental homes.

The expanded investment interest limitation also is unfair. A limited partner with unearned income from bonds, stocks, inheritances, etc. would not be affected by the limit. A limited partner with the same amount of income derived solely from work (i.e., earned income) would be subject to the limit.

The combination of the elimination of capital gains on the disposition of depreciable real estate and a reduction in the rate of the depreciation of structures under the CCRS depreciation schedule would reduce the overall yield on single-family rental partnership investments by 60%. To compensate for this reduced rate of return, single-family rentals would have to increase by 25%.[1] An increase of such magnitude would result in an increase in the average annual rent paid by a rental family of over $1,550. According to the Treasury, the same family would save at most $300-$400[2] under the President's proposals during the same period.

In the absence of the required rental increase in the short term, the production of new single-family rental homes would be reduced significantly. Such a reduction would exacerbate the current housing shortage, preventing millions of Americans from moving up to newer, better quality housing. Of course, as supply was reduced relative to demand, rental costs would increase anyway.

In addition to decelerating the depreciation of real estate, the proposed Capital Cost Recovery System accelerates dramatically the depreciation of equipment. Office computers, for example, would have a nearly tripled depreciation rate in the first year of use (from 15% under ACRS to 44% under CCRS). The CCRS depreciation schedule combined with the loss of capital gains treatment for real estate, (1) creates a 38% difference between the effective tax rate on investments in equipment (i.e., 18%) and the effective tax rate on investments in depreciable real estate (i.e., 25%) and results in a 22% difference between the internal rate of return on equipment investments and the internal rate of return on depreciable real estate investments.

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[1] See Appendix A, and compare Chart A-1 with Chart A-3.

[2] Figure supplied by Office of Tax Analysis, U.S. Treasury Department.

These dramatic differences in effective tax rates and internal rates of return are enough to "unlevel" the "playing field", forcing investment dollars that would have flowed into real estate, including single-family rental homes into equipment leasing investments. To the extent the additional equipment purchased as a result of the "unleveling" is manufactured overseas, the President's proposals will export American construction jobs, increase America's balance of trade and payments deficits and result in lost federal and local tax revenues.

APPENDIX A

CHART A-1

Tax Structure Analysis
Variable Financial Model

Current Tax Code
Current Average Rent

$1,000,000 Market Value
$850,000 Purchase Price

Initial Sources and Uses

-Sources-

$900,000 first trust

$900,000 total

-Uses-

$170,000	land
$680,000	structure
$40,500	commitment fee
$9,500	cash excess
$900,000	total

Assumptions

	one	two	three	four	five
1st trust					
a) balance / pp	90.00%				
c) term	***********(interest only)				
b) current rate	12.50%	12.30%	12.30%	12.50%	12.50%
d) accrual rate	0.00%	0.00%	0.00%	0.00%	0.00%
e) p.m.i.	0.35%	0.35%	0.55%	0.35%	0.55%
f) commitment fee	4.50%				
g) participation	0.00%				
discount	15.00%				
depreciation					
a) life (years)	18 (ACRS-SL)				
b) % land	20.00%				
c) % structure	80.00%				
net operating income	3.50%(result if rent 3% of market value)				
interest on surplus	12.00%				
interest on advances	15.00%				
organization expense	15.00%	15.00%	15.00%	15.00%	15.00%
inflation rate		7.00%	7.00%	7.00%	7.00%
tax bracket	50.00%	50.00%	50.00%	50.00%	50.00%
capital gain exclus.	60.00%	60.00%	60.00%	60.00%	60.00%
c.p.i. adjustment	0.00%				
write-off ratio	2.00	2.00	2.00	2.00	2.00
at sale apprec rates	5.00%	8.00%	10.00%		
sales expense	7.00%				

Cash Flow Analysis

	one	two	three	four	five	total
net operating income	$35,600	$37,530	$40,243	$43,152	$46,272	$202,198
debt service						
p.m.i.	($4,950)	($4,950)	($4,950)	($4,950)	($4,950)	($24,750)
p & i	($112,500)	($112,500)	($112,500)	($112,500)	($112,500)	($562,500)
net cash flow	($82,450)	($79,920)	($77,207)	($74,298)	($71,178)	($385,052)

Cash Management Account

add capital	$62,299	$63,145	$63,967	$64,755	$65,500	$319,665
cash flow	($82,450)	($79,920)	($77,207)	($74,298)	($71,178)	($385,052)
organization fee	($9,345)	($9,472)	($9,595)	($9,713)	($9,825)	($47,950)
beginning balance	$9,500	($20,316)	($51,165)	($82,839)	($115,479)	
interest	$320	$4,542	$8,899	$13,384	$17,993	$45,139
ending balance	($20,316)	($51,165)	($82,839)	($115,479)	($148,975)	

Tax Affect

	one	two	three	four	five	total
cash flow	($82,450)	($79,920)	($77,207)	($74,298)	($71,178)	($385,052)
principal (accrual)	($0)	($0)	($0)	($0)	($0)	$0
c.m.a. interest	$320	$4,542	$8,899	$13,384	$17,993	$45,139
depreciation	$37,778	$37,778	$37,778	$37,778	$37,778	$188,889
other deductions	$4,050	$4,050	$4,050	$4,050	$4,050	$20,250
total	($124,598)	($126,290)	($127,933)	($129,510)	($130,999)	($639,330)
capital	$62,299	$63,145	$63,967	$64,755	$65,500	$319,665
loss ratio	200.00%	200.00%	200.00%	200.00%	200.00%	200.00%
cummulative loss	($124,598)	($250,888)	($378,821)	($508,331)	($639,330)	

Resale Analysis

	5 years			4 years		
rate of appreciation	5.00%	8.00%	10.00%	5.00%	8.00%	10.00%
sale price	$1,283,359	$1,489,846	$1,645,309	$1,220,895	$1,375,666	$1,489,334
sale expense	$89,835	$104,289	$115,172	$85,463	$96,297	$104,235
net sales price	$1,193,524	$1,385,557	$1,530,137	$1,135,433	$1,279,369	$1,385,099
mortgage balance	$900,000	$900,000	$900,000	$900,000	$900,000	$900,000
c.a.a. balance	$148,975	$148,975	$148,975	$115,479	$115,479	$115,479
proceeds	$144,548	$336,581	$481,162	$119,954	$263,891	$369,620
lender participation	$0	$0	$0	$0	$0	$0
lp distribution	$144,548	$336,581	$481,162	$119,954	$263,891	$369,620
capital account	($319,665)	($319,665)	($319,665)	($254,165)	($254,165)	($254,165)
unamort points	$20,250	$20,250	$20,250	$24,300	$24,300	$24,300
gain on sale	$484,463	$676,496	$821,076	$398,419	$542,356	$648,086
exclusion	($290,678)	($405,897)	($492,646)	($239,051)	($325,413)	($388,851)
tax on sale	$86,768	$125,174	$154,090	$67,534	$96,321	$117,467
proceeds after tax	$57,781	$211,407	$327,072	$52,420	$167,569	$252,153
% of capital	18.08%	66.13%	102.32%	20.62%	65.93%	99.21%
r.o.i.	6.95%	25.44%	39.35%	6.72%	28.21%	43.99%
lender yield	13.24%	13.24%	13.24%	13.24%	13.24%	13.24%
economic break-even	7.75%			7.81%		
after tax break-even	3.87%			4.06%		

CHART A-2

Tax Structure Analysis
Variable Financial Model

$1,000,000 Market Value

Proposed Tax Code
$850,000 Purchase Price
Current Average Rent

Initial Sources and Uses

-Sources-

$900,000 first trust

$900,000 total

-Uses-

$170,000 land
$680,000 structure
$40,500 commitment fee
$9,500 cash excess

$900,000 total

Assumptions

	one	two	three	four	five
1st trust					
a) balance / pp	90.00%				
c) term	************(interest only)				
b) current rate	12.50%	12.50%	12.50%	12.50%	12.50%
d) accrual rate	0.00%	0.00%	0.00%	0.00%	0.00%
e) p.m.i.	0.55%	0.55%	0.55%	0.55%	0.55%
f) commitment fee	4.50%				
g) participation	0.00%				
discount	15.00%				
depreciation					
a) life (years)	18 (ACRS)				
b) % land	20.00%				
c) % structure	80.00%				
net operating income	3.30%(result if rent 3% of market value)				
interest on surplus	12.00%				
interest on advances	13.00%				
organization expense	15.00%	15.00%	15.00%	15.00%	15.00%
inflation rate		7.00%	7.00%	7.00%	7.00%
tax bracket	35.00%	35.00%	35.00%	35.00%	35.00%
capital gain exclus.	50.00%	50.00%	50.00%	50.00%	50.00%
c.p.i. adjustment	5.00%				
write-off ratio	2.00	2.00	2.00	2.00	2.00
at sale apprec rates	5.00%	8.00%	10.00%		
sales expense	7.00%				

Cash Flow Analysis

	one	two	three	four	five	total
net operating income	$35,000	$37,530	$40,243	$43,152	$46,272	$202,198
debt service						
p.m.i.	($4,950)	($4,950)	($4,950)	($4,950)	($4,950)	($24,750)
p & i	($112,500)	($112,500)	($112,500)	($112,500)	($112,500)	($562,500)
net cash flow	($82,450)	($79,920)	($77,207)	($74,298)	($71,178)	($385,052)

Cash Management Account

add capital	$57,192	$58,691	$60,171	$61,243	$62,664	$299,960
cash flow	($82,450)	($79,920)	($77,207)	($74,298)	($71,178)	($385,052)
organization fee	($8,579)	($8,804)	($9,026)	($9,186)	($9,400)	($44,994)
beginning balance	$9,500	($25,021)	($60,619)	($97,277)	($135,318)	
interest	$684	$5,565	$10,596	$15,300	$21,171	$53,817
ending balance	-($25,021)	($60,619)	($97,277)	($135,318)	($174,403)	

Tax Affect

	one	two	three	four	five	total
cash flow	($82,450)	($79,920)	($77,207)	($74,298)	($71,178)	($385,052)
principal (accrual)	($0)	($0)	($0)	($0)	($0)	$0
c.m.a. interest	$684	$5,565	$10,596	$15,300	$21,171	$53,817
depreciation	$27,200	$27,846	$28,489	$28,339	$28,929	$140,802
other deductions	$4,050	$4,050	$4,050	$4,050	$4,050	$20,250
total	($114,384)	($117,381)	($120,342)	($122,487)	($125,328)	($599,922)
capital	$57,192	$58,691	$60,171	$61,243	$62,664	$299,960
loss ratio	200.00%	200.00%	200.00%	200.00%	200.00%	200.00%
cumulative loss	($114,384)	($231,765)	($352,107)	($474,593)	($599,922)	

Resale Analysis

	3 years			4 years		
rate of appreciation	5.00%	8.00%	10.00%	5.00%	8.00%	10.00%
sale price	$1,283,359	$1,489,846	$1,645,309	$1,220,895	$1,375,666	$1,489,354
sale expense	$89,835	$104,289	$115,172	$85,463	$96,297	$104,255
net sales price	$1,193,524	$1,385,557	$1,530,137	$1,135,433	$1,279,369	$1,385,099
mortgage balance	$900,000	$900,000	$900,000	$900,000	$900,000	$900,000
c.e.a. balance	$174,403	$174,403	$174,403	$135,318	$135,318	$135,318
proceeds	$119,121	$311,154	$455,734	$100,115	$244,052	$349,781
lender participation	$0	$0	$0	$0	$0	$0
lp distribution	$119,121	$311,154	$455,734	$100,115	$244,052	$349,781
capital account	($299,961)	($299,961)	($299,961)	($237,297)	($237,297)	($237,297)
unamort points	$20,250	$20,250	$20,250	$24,300	$24,300	$24,300
gain on sale	$439,332	$631,365	$775,946	$361,711	$505,648	$611,378
exclusion	($199,866)	($219,070)	($233,528)	($160,500)	($174,893)	($185,466)
tax on sale	$76,725	$137,216	$182,759	$61,919	$107,259	$140,564
proceeds after tax	$42,395	$173,938	$272,976	$38,196	$136,792	$209,217
% of capital	14.13%	57.99%	91.00%	16.10%	57.65%	88.17%
r.o.i.	-6.15%	10.85%	23.64%	-9.78%	10.04%	24.60%
lender yield	13.24%	13.24%	13.24%	13.24%	13.24%	13.24%
economic break-even	7.84%			7.67%		
after tax break-even	6.39%			6.48%		

CHART A-3

Tax Structure Analysis
Variable Financial Model

$1,600,000 Market Value
$850,000 Purchase Price

Proposed Tax Code
25% Rental Increase

Initial Sources and Uses

-Sources-

$900,000 first trust

$900,000 total

-Uses-

$170,000 land
$680,000 structure
$40,500 commitment fee
$9,500 cash excess

$900,000 total

Assumptions

	one	two	three	four	five
1st trust					
a) balance / pp	90.00%				
c) term	************(interest only)				
b) current rate	12.50%	12.50%	12.50%	12.50%	12.50%
d) accrual rate	0.00%	0.00%	0.00%	0.00%	0.00%
e) p.a.i.	0.55%	0.55%	0.55%	0.55%	0.55%
f) commitment fee	4.50%				
g) participation	0.00%				
discount	15.00%				
depreciation					
a) life (years)	20	(ACRS)			
b) % land	20.00%				
c) % structure	80.00%				
net operating income	5.20%(result if rent 10% of market value)				
interest on surplus	12.00%				
interest on advances	15.00%				
organization expense	15.00%	15.00%	15.00%	15.00%	15.00%
inflation rate		7.00%	7.00%	7.00%	7.00%
tax bracket	33.00%	33.00%	33.00%	33.00%	33.00%
capital gain exclus.	50.00%	50.00%	50.00%	50.00%	50.00%
c.p.i. adjustment	5.00%				
write-off ratio	2.00	2.00	2.00	2.00	2.00
at sale apprec rates	5.00%	8.00%	10.00%		
sales expense	7.00%				

Cash Flow Analysis

	one	two	three	four	five	total
net operating income	$52,000	$55,759	$59,790	$64,112	$68,747	$300,408
debt service						
p.e.i.	($4,950)	($4,950)	($4,950)	($4,950)	($4,950)	($24,750)
p & i	($112,500)	($112,500)	($112,500)	($112,500)	($112,500)	($562,500)
net cash flow	($65,450)	($61,691)	($57,660)	($53,338)	($48,703)	($286,842)

Cash Management Account

add capital	$48,369	$48,495	$48,442	$47,804	$47,319	$240,429
cash flow	($65,450)	($61,691)	($57,660)	($53,338)	($48,703)	($286,842)
organization fee	($7,255)	($7,274)	($7,266)	($7,171)	($7,098)	($36,064)
beginning balance	$9,500	($14,874)	($38,747)	($61,917)	($84,503)	
interest	$37	$3,403	$6,685	$9,882	$12,957	$32,964
ending balance	($14,874)	($38,747)	($61,917)	($84,503)	($105,942)	

Tax Affect

	one	two	three	four	five	total
cash flow	($65,450)	($61,691)	($57,660)	($53,338)	($48,703)	($286,842)
principal (accrual)	($0)	($0)	($0)	($0)	($0)	$0
c.m.a. interest	$37	$3,403	$6,685	$9,882	$12,957	$32,964
depreciation	$27,200	$27,846	$28,489	$28,339	$28,929	$140,802
other deductions	$4,050	$4,050	$4,050	$4,050	$4,050	$20,250
total	($96,737)	($96,990)	($96,884)	($95,608)	($94,639)	($480,858)
capital	$48,369	$48,495	$48,442	$47,804	$47,319	$240,429
loss ratio	200.00%	200.00%	200.00%	200.00%	200.00%	200.00%
cumulative loss	($96,737)	($193,727)	($290,611)	($386,219)	($480,858)	

Resale Analysis

	5 years			4 years		
rate of appreciation	5.00%	8.00%	10.00%	5.00%	8.00%	10.00%
sale price	$1,283,359	$1,489,846	$1,645,309	$1,220,895	$1,375,666	$1,489,354
sale expense	$89,835	$104,289	$115,172	$85,463	$96,297	$104,255
net sales price	$1,193,524	$1,385,557	$1,530,137	$1,135,433	$1,279,369	$1,385,099
mortgage balance	$900,000	$900,000	$900,000	$900,000	$900,000	$900,000
c.e.a. balance	$105,942	$105,942	$105,942	$84,503	$84,503	$84,503
proceeds	$187,582	$379,615	$524,196	$150,930	$294,867	$400,596
lender participation	$0	$0	$0	$0	$0	$0
lp distribution	$187,582	$379,615	$524,196	$150,930	$294,867	$400,596
capital account	($240,430)	($240,430)	($240,430)	($193,110)	($193,110)	($193,110)
unamort points	$20,250	$20,250	$20,250	$24,300	$24,300	$24,300
gain on sale	$448,262	$640,295	$784,875	$368,340	$512,276	$618,006
exclusion	($179,866)	($219,070)	($233,528)	($160,500)	($174,393)	($185,466)
tax on sale	$79,851	$140,341	$185,884	$64,239	$109,579	$142,884
proceeds after tax	$107,731	$239,274	$338,312	$86,691	$185,287	$257,712
% of capital	44.81%	99.52%	140.71%	44.89%	95.95%	133.45%
r.o.i.	5.62%	26.37%	41.99%	4.12%	28.09%	45.70%
lender yield	13.24%	13.24%	13.24%	13.24%	13.24%	13.24%
economic break-even	5.67%			5.92%		
after tax break-even	4.19%			4.48%		

TESTIMONY OF W. WILSON GOODE
SUBMITTED TO THE SENATE
COMMITTEE ON FINANCE
JULY 17, 1985

Mr. Chairman and Members of the Committee, I am W. Wilson Goode, Mayor of the City of Philadelphia. I appreciate the opportunity to share with you my concerns regarding President Reagan's proposed repeal of the Historic Rehabilitation Tax Credit.

I have been actively involved in housing and community development in Philadelphia and throughout Pennsylvania for twenty years. In Philadelphia, very few other housing and commercial rehabilitation programs have worked so well and benefitted so many with minimal public expenditure as the Historic Rehabilitation Tax Credit program. This program is an effective and efficient housing and economic development program - one that has brought enormous benefits to communities across the nation. It has promoted stability and economic vitality in deteriorating neighborhoods while preserving buildings that are significant cultural, historical and architectural resources. I would like now to highlight briefly the Philadelphia experience to give you an idea of just how effective this program is.

Historic Rehabilitation in Philadelphia

In Philadelphia, the future of the past is a tremendous source of community pride and economic revitalization. As home of some of the most significant historic architecture in the country, Philadelphia is trying to preserve its heritage by turning its historic, yet abandoned and obsolete buildings, into vibrant, liveable and useable spaces. The Certified Historic Rehabilitation Tax Credit Program has helped this to happen. In addition, the program leverages substantial private investment and is labor intensive.

I might interject that these projects are by law "substantial rehabilitations" of "historically certified income-producing properties." In other words, individuals cannot use the tax credit to do a cheap renovation of their home. Every one of these projects is a substantial rehabilitation of a certified historic building that is income-producing.

The 25% historic rehabilitation tax credit has stimulated significant private investment in Philadelphia. Since late 1981, private investments totaling nearly $400 million have been invested or committed to be invested in renovating historically certified, commercial and residential buildings in Philadelphia. According to the National Park Service records, this investment created approximately 2000 housing units. I am very concerned about the impact that the repeal of preservation tax credits will have on our efforts to provide decent rental housing for Philadelphians.

Job Creation

Equally important are the jobs that have been created through the historic rehabilitation tax credits. Historic rehabilitation is an extremely labor intensive industry, nearly twice as much as new construction. Between 60 and 70% of the project costs are for labor. According to the most conservative estimates, nearly 9000 new, permanent jobs and approximately 5000 construction jobs were generated by certified preservation projects in Philadelphia since 1981. The private investment stimulated by preservation tax credits has spawned the growth of many small firms from architects to window renovators. These projects also have caused a rebirth of many of the dormant building trades, like plasterers, who have the skills to comply with the Department of Interior standards.

Philadelphia Model Projects

Let me turn now to share with you four Philadelphia projects I consider model historic rehabilitation tax credit projects.

1. The Frankford Arsenal

The Frankford Arsenal was a major site for the Army's research and development efforts from the Civil War through post-World War II. The Arsenal encompasses slightly over 100 acres and includes well in excess of 100 buildings. Before it closed in 1976, the Arsenal employed 4000-5000 people and was a major employer of workers from the predominantly ethnic, blue collar Bridesburg neighborhood. That community was devastated when the Army decided to close the Arsenal. For six years, the property stood vacant and threatened to blight the area.

Selling the Arsenal and luring new employers was difficult. The buildings needed renovation, the sewers and street lights needed maintainance, the central boiler and distribution system needed to be repaired and the surrounding streets were caving in. In order to induce businesses to risk investing in the Arsenal, the rents (at least in the early years) had to be low; but the cost of the debt service on the rehabilitation project along with operating costs would be high.

Finally in 1983, a developer acquired the property to convert the site into an industrial and office park with the assistance of historic rehabilitation tax credits. The Frankford Arsenal presently employs 500 and houses 33 companies including high tech companies, storage facilities, a hardware store, wholesale distributors, an assembly facility for a manufacturer, and various commerical offices. This is just the beginning of the revitalization of the Frankford Arsenal. The developer had hoped by the end of 1984 to have leased 93,000 square feet, but has in fact leased over 400,000 square feet. This figure constitutes less than one-half of the available space at Frankford. Upon completion, we project that the Arsenal will employ as many as 3000 people.

The preservation tax credit not only saved this area from blight but also stimulated $6.5 million in private investment. In addition, we estimate that the Arsenal generates over $1.6 million annually in Federal taxes from employee salaries.

(2) The Lit Brothers Project

This project is an amalgam of buildings which were constructed beginning in 1857 and is one of the most impressive collections of Victorian commerical building fronts anywhere in the country. The 13 buildings which comprise the Lit Brothers Project were constructed over a period of years, but were assembled into a single use which spanned the length of a city block.

The Lit Brothers buildings have been vacant since 1977. We have had two previous developers lose interest in their attempt to renovate the area. Moreover, the current developer is concerned that the repeal of the historic rehabilitation tax credit will jeapordize the project since it is in such an early stage.

This project is important to the City of Philadelphia for a number of reasons. It: (1) is the most blighting element of the City's retail district; (2) will preserve an important remnant of our past; (3) will serve as a connection between Independence National Historic Park and the Liberty Bell area to the heart of Philadelphia's shopping district; and (4) will stimulate approximately $60 million in equity investment. Moreover, the renovation of the Lit Brothers buildings will enhance the $310 million public investment in the commuter rail connection and the enormous public and private investment in Gallery I and II (the first major inner city retail development).

(3) Breslyn Apartments

In West Phildelphia, we renovated an abandoned apartment building, originally built in 1913, which stretches for nearly a city block into 60 units of low-to-moderate income housing. The Breslyn Apartments provide good quality low-income housing, including Section 8 housing, without displacing any of the neighborhood.

Preservation tax credits helped us to stimulate private investments of $2.3 million in the Breslyn Apartments and to reverse the trend toward decay in a neighborhood of predominately poor, minority, working class, and underemployed individuals.

4. Old City

Preservation tax credits transformed our Old City from a decaying warehouse district with many vacant and underutilized structures, into a dynamic community of historic residential and mixed use buildings resulting in a 300% increase in housing units and $125 million in investments since 1981.

Prior to the enactment of the historic rehabilitation tax credit in 1981, there were few Old City projects -- none of which had a significant impact on the surrounding neighborhood. After 1981, Old City witnessed burgeoning development. A representative of this is the Wire Works project, a massive five story wire factory built in 1900 that was converted into 97 rental apartments. The Wire Works and similar projects had an immediate and profound impact on the surrounding neighborhood. Subsequent to these developments, hundreds of new apartments, all done with historic rehabilitation tax credits have transformed Old City from a dying wholesale and warehouse district into one of Philadelphia's dynamic areas. New businesses have sprung up to serve the residents of this rehabilitated area (grocery stores, retail stores, dry cleaners, restaurants, etc.) which also have added to the revitalization of the area. At the same time many of the long-standing merchants and jobbers, who gave Old City its distinct character, have remained.

Other Philadelphia Examples

In summary, the wide variety of these projects has revitalized neighborhoods once thought to be lost as historic buildings fell prey to urban blight in Philadelphia. Previously vacant buildings, such as the Benjamin Franklin Hotel, stand again as proud architectural landmarks but with renewed purpose -- to fulfill the rental housing needs of Philadelphians. Less dramatic perhaps, yet equally as significant, are the historic rehabilitations of decaying storefronts in Manayunk and dilapidated rowhouses in the Parkside section of West Philadelphia. In addition, several non-profit groups are currently using the historic rehabilitation tax credit in conjunction with other subsidies to provide low-and-moderate income housing in North and West Philadelphia and Germantown. The Breslyn and Monte Vista have become models of community development for low-and-moderate income neighborhoods. Neither of them would have been possible without the tax credit. In short, the preservation tax credit has breathed new life into our decaying historic structures and stimulated tremendous investment in the rehabilitation of our center city and neighborhoods.

Historic Rehabilitation in Smaller Pennsylvanian Cities & Municipalities

I want to point out that the urban significance of the certified historic rehabilitation tax credit program is not unique to Philadelphia. In Pittsburgh, preservation tax credits helped to renovate neighborhoods such as the Strip and the North Side. Let me add that this is not just a big city program. The benefits of this program have spread to many small cities and municipalities across the country.

In Pennsylvania, more than 25% of all the historic rehabilitation projects have occurred in small towns. For these areas, the revitalization of main street is now the mainstream of their future growth and opportunity. Preservation tax credits are responsible for the renaissance of many of our smaller cities. For example, the following projects are using or have used historic preservation tax credits.

1. The 1910 Harrisburg Old City Hall, (which was vacant for several years) was converted into 80 middle income housing units. The project is also breathing life into the city by drawing people into Center City to live. This serves as a catalyst for restaurants, and other related service industries to locate there as well.

2. Across the river from Harrisburg, in a small, 10,000 person community, the Mechanicsburg High School (which had been vacant for five years) is being converted into 60 rental housing units.

3. An abandoned shoe factory (which was vacant for 5-10 years), in the small community of Palmyra will become 41 middle-income apartment units available to the blue collar community that surrounds it; and

4. In Allentown, the ripple effect of preservation credits is evident as its historic rehabilitaion projects not only prevent blight resulting from abandoned buildings but also have acted as a catalyst for individuals in the neighborhood who decided to restore their homes --- at their own expense. Since January 1, 1985, the Allentown Historic Districts Review Board has reviewed sixty-two applications for rehabilitation of private homes for which the taxpayer would receive no Federal rehabilitation tax credit.

My testimony today has attempted to show you just how effective the historic rehabilitation tax credit program has been in Philadelphia. I've described tremendous economic development and community benefits, project variety, neighborhood diversity, and private investment stimulated by these credits.

I understand how difficult it is to write a revenue neutral tax reform bill that is simple and fair and yet maintains incentives important to the nation. I ask you to consider the impressive record of the historic rehabilitation tax credit program in stimulating the revitalization of our cities and inducing preservation of our architectural heritage. The historic tax credit was enacted to create development through rehabilitation -- and it has. Please help me and other city officials across the nation, from small and large cities, to maintain a program that works and that is a vital part of our economic development efforts.

0507L

STATEMENT OF

HOUSING AMERICA FOUNDATION

COMMITTEE TO PRESERVE MORTGAGE INTEREST DEDUCTION

to the

FINANCE COMMITTEE

UNITED STATES SENATE

on

LIMITATION OF INTEREST DEDUCTION

September 15, 1985

Mr. Chairman and Members of the Committee:

My name is William Bone. I am Chairman of the Board of Sunrise Company from Palm Desert, California. Sunrise Company is a large, diversified real estate investment and development firm; among other things, we are one of the largest builders of second homes in the United States. I also am a Director of the Housing America Foundation (HAF) and the Co-Chairman of its Committee to Preserve Mortgage Interest Deduction. HAF is a coalition of individuals concerned about the future of housing in America. HAF was established to preserve and reaffirm the nation's long-standing commitment to provide decent, affordable housing for all Americans. In addition to these involvements, I helped organize Residential Research Associates, a nationwide coalition of individuals, businesses and labor leaders who are concerned about the economic well-being of the economies of isolated geographic areas that are heavily dependent upon the second home industry.

1. Present Law

In general, present law allows a deduction for interest paid or incurred on indebtedness during the taxable year (Code sec. 163(a)). This provision has been part of the tax law since the enactment of the Revenue Act of 1913. Since that time, there has been no limitation on the deductibility of either personal interest, or interest on funds borrowed in connection with the taxpayer's trade or business. However, present law does impose a limitation on the deductibility of investment interest (Code sec. 163(d)).

The investment interest limitation, first enacted in 1969, was designed to limit the extent to which a taxpayer can reduce tax on income from his professional or income-producing activities by incurring an unrelated non-business deduction. Under that provision, deductions for interest on indebtedness incurred to purchase or carry property held for investment is generally limited to $10,000 per year, plus the taxpayer's net investment income. This limitation has no impact on personal interest deductions (e.g., interest incurred to purchase a second home). Investment income is non-business income which is interest, dividends, rents, royalties, short-term capital gains, and any gain treated as ordinary income under the depreciation recapture provisions.

2. Administration Proposal

The Administration has proposed expanding the investment interest limitation. The proposal would include as investment interest all interest that is not incurred in connection with a trade or business, except home mortgage interest on the taxpayer's principal residence. Thus, the proposal would apply to all "consumer interest".

Interest subject to limitation would be deductible only to the extent of $5,000 ($2,500 for a married person filing a separate return), plus the taxpayer's net investment income. Interest that is disallowed for the taxable year would be treated as interest subject to the limitation for the succeeding taxable year.

The Administration proposal would be phased in under two separate transitional rules over a ten-year period, beginning in 1986.

3. Economic Impact Studies

As noted above, the proposal would limit the deductibility of all interest other than that with respect to businesses or principal residences. Thus, the interest deduction limitation would apply to interest on second homes and automobile purchases, interest paid or incurred by limited partners, and interest paid on other consumer loans (e.g., loans to finance a college education, appliances or home furnishings). HAF primarily is concerned with the impact of the proposed limitation on the deductibility of the second home mortgage interest.

Two major studies have been completed analyzing the proposal's impact on the second home industry and on the local economies across the Nation that depend on the second home industry for their economic well being. The studies were performed by Economics Research Associates (ERA) and Data Resources, Inc. (DRI). The two firms approached their studies differently. ERA conducted an extensive, national telephone survey of existing second home owners and prospective second home purchasers in order to determine whether and how these people would act differently if the tax proposal were adopted and then to quantify the economic impact of any change in their investment and consumption behavior. DRI used its econometric computer model of the United States economy to analyze and quantify the proposal's economic impact.

While the results of the two studies were not precisely the same, both studies reached the same general conclusions. These conclusions are the basis for our opposition to the provision in the tax proposal that would limit the deductibility of interest on second home mortgages.

In summary, we believe--and the studies confirm--that the proposal is economically unsound, unfair and fails to achieve the Administration's tax reform objectives.

4. The Proposal is Economically Unsound

The second home industry is a significant and important segment of the economy. There are an estimated 4.5 million second homes in the United States; about 105,000 second homes are constructed annually. The second home industry supports over 2,400,000 construction and service jobs, as well as many local economies. Of 3,138 counties in the United States in 1980, 899 counties have greater than 10% of their housing in non-primary units; 329 counties have greater than 20% in non-primary units; and 923 counties have greater than 1,000 non-primary units.

Limiting deductibility of second home mortgage interest will cause a 39% decline in second home purchases. ERA found that over half of the prospective second home purchasers and lot owners are presently delaying decisions to purchase or build because of the pending tax proposals. Members of our Coalition--from Hawaii to Florida--have experienced severely declining sales rates over the past ten months since tax reform was first proposed and publicized. The uncertainty about the tax changes is causing major negative effects right now.

Construction activity is expected to decline substantially from 105,000 units per year. Reduced future demand over the next five years would lead to lost construction of 375,000 units with a value of over $26 billion.

Employment will decline along with construction activity. 323,000 jobs will be lost, with a devastating impact on the isolated economies that depend on the second home industry.

The market values of existing second homes will decline by up to 15%. The value of primary homes in the affected areas will similarly decline.

Reduced property values will lead immediately to an annual loss in revenues to local government, including counties, cities, school districts and utility districts, of more than $245 million. By the fifth year, annual local government revenue losses will be over $500 million. This shortfall will have to be made up by either (a) raising property taxes (which may be impossible in states like California because of Proposition 13) or, (b) obtaining subsidies from the state or federal government.

5. The Proposal is Unfair

The impact of the proposal will be borne largely by middle class America--not by the wealthy as is often assumed. ERA found that the median family income of second home owners is $45,000 to $55,000. The median value of second homes is $68,000.

The decline in property values will affect not only persons owning second homes, but also those who own primary homes within the affected areas. This is unfair to these permanent residents.

Middle American working families could lose a sizable portion of their life savings if there is a decline in the value of second homes and primary homes in the affected areas. Affluent second home owners are affected very little because a second home represents a much smaller portion of their assets.

The proposal is discriminatory against younger and less affluent people with little or no net investment income. Wealthy people with substantial net investment income will continue to deduct all of their interest on second home mortgages.

The proposal imposes a disproportionate burden on the isolated economies that depend on the second home industry and an emotional and financial hardship on the people who live there. Typically, these areas have only two basic industries, construction and tourism--everything else services these two groups. Persons displaced from jobs in these areas cannot expect to find employment locally, but will be forced to sell their homes at depressed prices and move to other geographical regions.

6. The Proposal Does Not Achieve the President's Tax Reform Objectives of Fairness, Economic Growth, Simplicity and Revenue Neutrality

As explained above, the proposal is not fair for a number of reasons.

The proposal will not stimulate economic growth. Rather, the result of the proposal would be to depress local economies dependent upon growth in construction of second homes and to divert spending from domestic construction activity to alternative consumption, a significant portion of which would be of foreign produced goods. DRI estimates that the net effect will be a reduction in Gross National Product of over $1 billion during the first two years.

The proposal does not result in simplification. Instead, it encourages the use of various tax avoidance schemes such as borrowing against the primary home for the purpose of buying a second home or other consumer credit needs.

The proposal would not increase federal tax revenues as suggested by the Treasury Department. Instead, because of lower employment and resulting lower firm profitability, revenues would be decreased by $2.9 billion during the first two years.

7. Conclusion

HAF urges the Committee to consider carefully the potential consequences of limiting the deductibility of second home mortgage interest. We believe the Committee must conclude, as we have, that the proposal is economically unsound, unfair and fails to achieve any meaningful tax reform objectives.

TESTIMONY OF

THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS

ON

THE IMPACT OF TAX REFORM ON REAL ESTATE

PRESENTED BY

JOHN J. SZYMANSKI
VICE PRESIDENT AND DIRECTOR OF TAXES

THE ROUSE COMPANY
COLUMBIA, MARYLAND

TO

THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

July 16, 1985

STATEMENT

I. INTRODUCTION

My name is John J. Szymanski. I am Vice President and Director of Taxes of The Rouse Company of Columbia, Maryland. We are real estate owners, developers, and managers. I also am a member of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC). I am presenting this testimony on behalf of the members of ICSC.

ICSC is the trade association of the shopping center industry. ICSC has approximately 14,000 members, consisting of shopping center developers, owners, operators, tenant retailers, lenders, and related enterprises. The ICSC represents a majority of the 25,000 shopping centers in the United States.

II. THE SHOPPING CENTER INDUSTRY

It is estimated that in 1984 shopping centers accounted for 45 percent of total U.S. retail sales, and that this figure will increase to between 50 percent and 55 percent by 1990. In current dollar value, U.S. shopping center retail sales reached a level of $475 billion in 1984.

It also is estimated that 65 percent of all the stores in shopping centers are independent operators or outlets of local chains. It further is estimated that between 5.7 and 6.5 million people are regularly employed in shopping centers and that several hundred thousand more are directly engaged in the new construction, expansion, and renovation of shopping centers. The additional effect of shopping center development on employment in related businesses, including the manufacture of goods sold in the centers, advertising, maintenance, and cleaning is considerable.

III. ICSC POLICY RECOMMENDATIONS

ICSC supports the improvement of the federal tax system to achieve greater economic growth, fairness, and simplicity. We believe that an overhaul of the tax code may benefit the economy if it is done properly. ICSC is willing to work with Congress, the Treasury Department, and other industries on the provisions that impact the real estate industry to assure that such changes would improve the operation of the real estate industry.

We in the shopping center industry are willing to carry our fair share of the nation's tax burden. Accordingly, we are willing to consider changes in the tax laws provided they do not discriminate against real estate, do not unduly favor other business interests in comparison with our industry and do not have a negative effect on the economy.

Congress should not enact legislation that would impair the ability of the entrepreneurial developer-owners of shopping centers to perform their essential roles in our nation's production and distribution system. These entrepreneurial developers of shopping centers have created a new form of real estate that is the most efficient retail mechanism ever devised. They have done this through the creation of a facility designed to serve the retail needs of the surrounding community, through their willingness to take risks, and through their creation of the institutional arrangements that allocate these risks among equity and debt holders. This existing system of entrepreneurial developer-owners, limited-risk investors, and institutional lenders should not be disrupted without a compelling reason.

ICSC has reviewed the President's tax proposals, and we find that several of the President's proposals would discriminate against real estate development. Also, we believe that the proposals in their entirety would disrupt the way the real estate industry currently operates. The short-term effects would be a substantial reduction in the economic activity. In the long term, a differently structured real estate development industry would exist, which would be dominated by financial institutions, insurance companies, and tax exempt retirement plans. It is not clear that such a structured real estate industry would serve the nation as well as the existing industry does today.

If tax reform is to be accomplished without disrupting the economy and our industry, certain improvements are essential to increase the neutrality of the proposals among asset types and ownership arrangements and to limit or eliminate several provisions that discriminate against our industry. These provisions discriminate:

- against direct investment compared to indirect investment (by providing preferential capital gains treatment for securities which often are held for relatively short periods of time but not for the underlying depreciable property which is traditionally held for periods in excess of 10 years);
- against investments in structures compared to investments in equipment (by establishing depreciation rates that would result in effective tax rates for structures one-third higher than for all other classes of assets);
- against productive assets compared to nonproductive, speculative assets, such as gold (by giving

preferential capital gains rate for such nondepreciable property but not for structures);

- against individuals, limited partnerships, and S corporations compared to C corporations (by applying the at-risk and interest limitation rules to all individuals and partners but not to most corporations and by permitting the capital gains exclusion for securities but not for depreciable property);
- against new entrants compared to established investors and against small and medium-sized investors and limited partners and passive Sub S shareholders as compared to wealthy individuals and large corporations (by the differing impact of the expanded investment interest limitation provision on these various categories of taxpayers); and
- against taxpayers who were most responsive to the investment incentives of ACRS compared to those who were less responsive (by the depreciation recapture provision that strikes most heavily at taxpayers who invested the most over the last five years).

We strongly urge Congress to move with great caution in considering the series of major changes in the tax law proposed by the President. The risk of disrupting the economy is substantial and the consequences of such disruption could have a serious impact on economic growth and employment.

IV. DISCUSSION OF INDIVIDUAL PROPOSALS

A. At-Risk Rules

1. Current Law

In general, individuals and certain closely held corporations are limited in the amount of loss they may deduct from an investment to the amount they have "at risk" with respect to that investment. A taxpayer is "at risk" in an investment to the extent that he has contributed unrecovered capital to the investment or is personally liable to repay debt used in the investment. A taxpayer is not at risk with respect to nonrecourse debt. Disallowed losses are carried forward and allowed to the extent that the taxpayer increases the amount at risk in subsequent years.

The at-risk rules do not apply to real estate activities, a closely held corporation actively conducting a business activity, or a widely held corporation investing in any activity.

2. President's Proposal

The at-risk rules would be extended to the real estate activities of individuals, partnerships, closely held, and Sub S corporations. The rules would not be extended to other C corporations currently not subject to them.

The proposal would be effective for losses attributable to property acquired after 1985.

3. ICSC Position

The real estate exemption from the at-risk rules should be continued for limited-risk loans made by unrelated institutional lenders. This exemption has permitted institutional arrangements for the sharing of risks among developer-owners and lenders. Total repeal of this exemption would seriously curtail the capacity of the most efficient and experienced developers of real estate to finance projects because borrowers' debt-equity ratios shown on their financial statements would become unacceptable to lenders. Since repeal would have a negative effect on real estate investment, increase complexity and raise little or no revenue, there is no compelling reason to change the law. Any alleged artificial inflation of basis for depreciation purposes could be avoided by limiting the at-risk exemptions to real estate loans by unrelated, third-party, institutional lenders.

4. Arguments

a. The Traditional Use of Limited-Risk Debt For Real Estate is Justified By Sound Theoretical and Economic Reasons

Nonrecourse debt has been used to finance real estate transactions without any limitation on the deductibility of losses since 1947, when the Supreme Court upheld this practice in *Crane v. Commissioner*, 331 U.S. 1 (1947). That decision recently has been reaffirmed by the Supreme Court in *Commissioner v. Tufts*, 461 U.S. 300 (1983).

Unlike most other activities to which the at-risk rules now apply, limited-risk financing is customary in commercial real estate transactions and has been for several decades. In addition to its tax implications, nonrecourse debt is used in real estate transactions for reasons which have nothing to do with the tax consequences of such loans.

As the Treasury has indicated in its proposals, some states prohibit the use of recourse debt for the acquisition of certain real estate, and in those states certain real estate activity can not proceed without the use of nonrecourse debt.

However, the primary reason for the use of nonrecourse debt is to shift the risk of loss from individual developer-owners and investors to lending institutions which are in the business of accepting such risk.

Developers of real estate generally are fully at risk during the construction period. They tolerate this risk because it is for a limited time only. The risk is reduced when the project is completed by the developer securing limited-risk, permanent financing.

Nonrecourse debt is commercially reasonable. Because of the intrinsic value of real estate and related tenancies, the lender looks to the property and the business skills of tenants as security for its loan, and not to the earning capacity or other assets of the borrower.

In addition, it is important to recognize that nonrecourse debt is not completely risk free to the borrower, as the Supreme Court recognized in Crane. There is great pressure on the developer to avoid foreclosure on property subject to a nonrecourse loan because foreclosure would destroy the developer's equity in the investment, tarnish his reputation, and limit his ability to obtain financing for other projects in the future. Developer-owners do not proceed with risks of development without a substantial equity potential beyond any mortgage debt. Indeed, as the Supreme Court noted in the Crane case, where a taxpayer has sufficient equity in the real property securing a loan, recourse and nonrecourse debts become functionally indistinguishable.

b. Adverse Effects of the Proposal

Without any economic justification, the application of the at-risk rules to real estate would force investors to choose between accepting the risk of recourse financing with current deductions or accepting the protection of nonrecourse financing with the delay or loss of valid deductions.

By forcing the use of recourse financing as a condition for taking valid deductions, the at-risk rules limit the ability of markets to spread risk according to various investors' ability and willingness to bear them. The application of the at-risk rules to real estate could disrupt the existing risk-allocation and financing system employed by the entrepreneurial developer-owners of shopping centers.

The application of this rule would severely restrict the ability of a developer-owner and other general partners to finance additional real estate projects. This is because the use of recourse debt would result in the inclusion of the full amount of the partnership's liability on the balance sheets of each of the general partners. Under current accounting rules, only the partner's share of the partnership's net equity (the value of the assets less the liability) is shown on each partner's balance sheet. This change in the developer-owner's balance sheet would substantially limit the number of projects a developer could develop. This would deprive the economy of the services of the most efficient and experienced producers of shopping centers and other real estate facilities.

By forcing the use of nonrecourse financing to obtain protection against risk at the cost of the loss of or delay in taking valid deductions, the at-risk rules promote economic inefficiency and are unfair.

The costs of nonrecourse loans are as much of a cost as those of any other loans and should be deductible without limit from a taxpayer's income before computing tax liability. In the Crane case, the Supreme Court felt that a rule that limits the amount of loss to the equity invested in a property would be unfair since depreciation deductions would be limited to "a fraction of the cost of the corresponding physical exhaustion of the property." A property wastes without regard to the method by which it is financed, and to limit depreciation deductions because of such a distinction would be discriminatory and unreasonable.

The consequences of extending the at-risk rules to real estate would be to dampen investment in real estate for the following reasons.

First, with nonrecourse financing, the after-tax returns on real estate investments would be reduced for those investors who were not able to deduct all their losses currently.

As a result, such investors would reduce their investment in real estate.

Second, with recourse financing, the risk of developing and holding real estate would increase for investors desiring a deduction for the full amount of their losses. More risk-adverse investors would be driven out of the real estate business.

As a result, there would be a reduction in real estate activity that would reduce jobs and economic activity.

Also, under the at-risk rules, losses would not be currently deductible after the cumulative losses exceed the amount that the taxpayer had at risk, and the deductibility of losses would be delayed until the taxpayer achieved a positive at-risk basis in the future. As a result, the taxpayer would be forced to prepay tax, and, in effect, give the government an interest-free loan. In addition, such an operation of the rules would encourage the early turnover of real property, and promote churning.

The at-risk rules would create additional complexity and administrative problems since they would require in effect an additional system of accounting for substantially more taxpayers and since there is great ambiguity about the operation of the current at-risk rules and their regulations.

c. The Proposed Change is Unnecessary, Produces No Revenue, and is Discriminatory

The extension of the at-risk rules with the resulting adverse effects is unnecessary for the following reasons.

First, there would be little or no revenue gain. The existing system of the production of real estate by developer-owners would be endangered for an estimated revenue increase of only $200 million over five years, with none of the revenue increase occurring until 1989. This estimate apparently assumes that the proposal would have no impact on the amount of investment in real estate. This assumption is erroneous and when the feedback effect of reduced investment is considered it is likely that there would be a net revenue loss from this proposal. The revenue estimate shows a five-year gross revenue gain from individuals of $1.5 billion which is offset by a revenue loss from corporations of $1.3 billion. Thus, the assumed beneficial effect of the proposal apparently would be to shift investment from individuals to corporations.

Second, partnership tax law changes made by the Deficit Reduction Act of 1984 effectively have eliminated the abusive tax shelter opportunities from nonrecourse debt.

Third, extending the at-risk rules to real estate without also extending them to corporations conducting a business would be discriminatory. Corporations would be allowed to offset loans from one activity against income from another activity, while individuals would not.

B. Interest Limits

1. Current Law

Interest expense is generally fully deductible, except for debt incurred to purchase obligations that generate tax-exempt income. However, for noncorporate taxpayers, interest on debt incurred for investments and interest on certain net leased business income property are deductible only to the extent of the sum of net income from investment assets and from net-leased business income property, plus $10,000 (for a joint return). In respect to net leased business income property, an additional "cash-flow qualifying test" permits deductions to the extent of "out-of-pocket" expenses. Amounts disallowed under these limitations may be carried forward.

2. President's Proposal

Individuals would not be allowed a current deduction for interest expense in excess of the sum of: passive investment income, mortgage interest expense on the taxpayer's principal residence, and $5000 (for a joint return). Interest expense subject to the limitation would include all interest not incurred in connection with a trade or business (except for interest on the taxpayer's principal residence) and the taxpayer's distributive share of the net interest expense as a limited partner and his share of the net interest expense of S corporations in which the taxpayer is a passive investor. This provision does not change the present law as to deduction of interest by general partners and managing Sub S shareholders. Nor does the proposal provide a "cash-flow" qualifying test for limited partners and passive Sub S shareholders. It should be noted that the application to interest of limited partnerships and Sub S corporations is not restricted to the types of interest which would be considered by such entities as "investment interest or net leased business income property interest."

This provision would be effective after 1985, subject to two phase-in rules: 1) the current $10,000 limit would be effective until 1988, then the $5,000 limit would apply; and 2) the interest expense items not currently subject to limitations (consumer interest expense and interest expense passed through from limited partnerships or S corporations) would be phased-in over 10 years at 10 percent of the interest for those items per year, as would the expanded definition of interest income.

3. ICSC Position

The current investment interest limitation works harshly because it denies a deduction for a current, real cash outlay. It discriminates against small and medium-sized investors compared to wealthy persons, against new entrants compared to established investors, and against individuals as compared to C corporations. The rule should not be made more onerous by expanding it to include the allocable trade or business interest expense of limited partners and passive S corporation investors as items of interest expense subject to the investment interest limitation. It would be grossly unfair to make an expanded rule retroactive to existing loans.

4. Arguments

a. Adverse Effects of the Existing Rule

The proposed expanded interest limitation would increase the negative economic impact of the existing investment interest limitation rule. The current rule works harshly because it denies a deduction for a current, real cash outlay which in no way is an artificial accounting loss. When interest rates are high, as they have been for the past few years when much debt was incurred, this problem is even more severe. The application of the rule produces an artificial taxable gain not matched by real cash income.

The existing rule discriminates against new entrants to the real estate business who lack capital and must use substantial debt to purchase properties. Because of this rule, they may not be able to deduct all of their interest expenses. Entrenched operators, however, have the income from mature properties to fund subsequent development projects or to offset the interest expenses from debt they do incur.

The rule is discriminatory against small and medium-sized investors as compared to wealthy persons because persons with substantial passive investment income, such as income from bonds, can deduct substantial amounts of excess investment interest and excess net leased business income property interest.

The rule also discriminates against individuals because it does not apply to most corporations.

b. Negative Effects of the Proposal to Expand the Rule

This proposal would reduce the amount of new captial formation and activity in real estate by discouraging entry into the real estate development business by new entrepreneurs and less wealthy investors. The discriminatory effect of the existing rule would be both expanded and made retroactive by the President's proposal.

The rule would be expanded by including within the interest expense limitation consumer debt and interest expense incurred in a trade or business by a limited partner or a passive S corporation investor. Its application also would be expanded by reducing the deductible amount of interest in excess of investment income from $10,000 to $5,000. With the amount of debt typically needed to finance a new car and a home improvement not secured by a mortgage, the ordinary investor would have little or no deductible amount left to qualify investment interest expense and net losses of limited partners and Sub S shareholders in excess of investment income and net leased business property income.

The limitation would be made retroactive by applying it to all interest paid in taxable years after 1985, subject to a 10-year gradual phase-in, regardless of when the debt was incurred. This retroactive effect is grossly unfair because it violates the justifiable expectations of taxpayers by making expenses nondeductible that were fully deductible when the investment was made.

C. Capital Gains

1. Current Law

Gains from the sale or exchange of non-dealer property held more than 6 months are treated as long-term capital gains. Losses on sale of investment property held more than 6 months are treated as long-term capital losses. For individuals and other noncorporate taxpayers, 60 percent of net long-term capital gain is excluded from income, resulting in a maximum marginal tax rate on capital gains of 20 percent (40 percent of the gain is taxed at a 50 percent tax rate). For corporations, the maximum 46 percent tax rate is reduced to 28 percent for capital gains.

Individuals and other noncorporate taxpayers deduct net short-term or long-term capital losses first against net long-term or short-term gain, and generally may take up to $3,000 per year of any net capital loss (but only one half of long-term loss) per year against ordinary income. Net capital loss in excess of $3,000 may be carried forward. For corporations, net short-term or long-term capital loss is offset against long-term or short-term gain, but excess capital losses are not deductible although they may be carried back three years and forward five years as a capital loss.

Special rules apply to Section 1231 property, which includes depreciable or real property held for more than six months and used in a taxpayer's trade or business, but not included in inventory or held primarily for sale in the ordinary course of business. This includes most commercial real estate. Gains and losses for all transactions involving Section 1231 property are netted. If there is a net Section 1231 gain, it is treated as a long-term capital gain, whereas a net Section 1231 loss is treated as a business loss.

Capital gains are calculated based on adjusted book value with no adjustment for inflation.

2. President's Proposal

For depreciable property, such as structures, the long-term capital gains exclusion would be repealed and all gain would be taxed at ordinary rates. However, gain would be calculated after adjusting for inflation and the top marginal tax rate would be reduced from 50 to 35 percent for individuals and from 46 to 28 percent (marginal non-capital gain rate would be 33 percent) for corporations. Losses from the sale or disposition of depreciable property would be fully deductible against ordinary income.

For nondepreciable property, the capital gains exclusion for noncorporate taxpayers would be decreased from 60 to 50 percent.

Under the proposed lower tax rates, the maximum tax rate on nondepreciable property would be reduced from 20 to 17.5 percent for individuals but would remain unchanged at 28 percent for corporations. Beginning in 1991, individual taxpayers could elect to index the basis of their nondepreciable capital assets for inflation in lieu of the preferential capital gains tax rate.

The proposal to repeal the exclusion for depreciable property would apply to property placed in service after 1985. The proposal to reduce the exclusion for nondepreciable property would be effective on July 1, 1986.

3. ICSC Position

Depreciable and nondepreciable property both should have an option of either adjusting the basis of the property for inflation and receiving ordinary income treatment of gain or of receiving capital gains treatment on unadjusted basis. Denying capital gains treatment to depreciable property will reduce capital investment in depreciable property, "lock-in" investors in such property, discourage direct investment in productive real property in favor of passive investment in securities and speculative commodities, and discriminate against property ownership by individuals as compared to corporations.

4. Arguments

a. Reduction in Savings and Investment

Previous changes in the taxation of capital gains have shown that the rate of capital formation is highly sensitive to the tax treatment of capital gains.

In 1978, Congress reduced the maximum capital gains tax to 28 percent. As expected, this change resulted in a substantial increase in available venture capital. Again, in 1981, Congress reduced the maximum capital gains tax rate from 28 to 20 percent, and again there was a substantial increase in the amount of capital formation.

The President's proposal would reverse this pro-capital formation policy by increasing the capital gains tax rate for depreciable property from 20 to 35 percent. This near doubling of the tax rate on capital gains of depreciable property would not be matched by any more favorable treatment for losses for Section 1231 property, which comprises virtually all rental income properties, since under current law net losses from such properties are fully deductible against ordinary income.

b. Lock-In of Capital

When higher tax rates are applied to gains of appreciated capital, taxpayers are encouraged to retain such property. This distorts investment, creates economic inefficiency, and reduces federal tax revenue.

By nearly doubling the tax rate on depreciable property, many taxpayers will be deterred from selling their real property when it would be economic to do so. The inflation-adjusted basis does ameliorate this effect, but inflation must be very high to equal the current capital gains exclusion. For example, for the ordinary income tax on inflation-adjusted gain on depreciable property to equal the proposed 50 percent capital gains exclusion for nondepreciable property at the minimum 6-month holding period for capital assets, the inflation rate would have to be 100 percent. At a 5 percent inflation rate, the property must be held for at least 15 years before the tax rate on inflation-adjusted depreciable property would be as low as the tax rate on nonadjusted capital assets with a 50 percent exclusion.

This lock-in effect is particularly unfair for individuals who own family businesses. They cannot assume that their business will continue indefinitely, as a large corporation can. They may be forced to sell because of illness, retirement or another family need. Even though they may intend to hold the property for more than the 15-year period required for the proposed treatment of gain to have the same tax rate as current law, they may be forced to sell before that time.

c. Discrimination Against Individual Ownership

This proposal would discourage direct investments in productive real property and encourage investments in stocks and bonds and other nondepreciable property, such as gold and silver, gems, and other collectable, nonproductive assets. This would discourage active investment and encourage passive investment and speculation. This is not good economic policy.

This proposal also discriminates against individual ownership and encourages corporate ownership because of the favorable treatment of gains on securities. The increased use of the corporate form of ownership would increase the amount of income and gain subject to double taxation, a problem recognized in the President's proposal and remedied in small part by the 10 percent dividend-paid exclusion.

D. Depreciation Recapture

1. Current Law

No provision.

2. President's Proposal

Some of the depreciation deductions taken between January 1, 1980, and July 1, 1986, on property placed in service between January 1, 1980, and January 1, 1986, would be included in income in the tax years 1986 through 1988. For taxpayers with more than $400,000 in total depreciation deductions taken in 1980 thorugh 1985, the amount recaptured would be 40 percent of the difference between the depreciation deductions taken and the deductions that would have been allowed under the applicable provisions governing the calculation of corporate earnings and profits, less a $300,000 exemption. For 18-year property and low-income housing, the applicable provisions are straight-line depreciation over 35 years for property placed in service before

September 30, 1984, and straight-line depreciation over 40 years for property placed in service after that date.

This proposal is justified by the President on the basis that it prevents an "unexpected windfall" for taxpayers who have deferred tax liability by taking accelerated depreciation deductions at higher pre-reform tax rates, but who would repay this deferred tax liability at lower post-reform tax rates. Under this provision they would pay for the "unexpected benefit" of the reduction of tax rates.

For calendar year taxpayers, 12 percent of the excess depreciation would be included in income in 1986, 12 percent in 1987, and 16 percent in 1988.

3. ICSC Position

This proposal should be rejected because it is a retroactive penalty applied to persons who were most responsive to the investment incentives of ACRS as Congress and the President intended. This tax would be imposed without regard to income or cash flow, without relation to the disposition of the property or any other taxable event, and with no adjustment of basis. This provision is unfair and would cause a substantial hardship for many taxpayers. This retroactive tax would set a damaging precedent making investors much less confident of any tax incentives in future legislation.

4. Arguments

In 1981, ACRS was established to encourage new capital investment in order to stimulate capital formation, increase productivity, and improve the nation's competitiveness in international trade. Members of ICSC responded to the investment incentives of ACRS as the Congress and the President intended, and invested in structures essential to the retail link in our production and distribution chain.

This proposal is objectionable for the following reasons:

First, it would retroactively reverse the pro-investment policy established by ACRS. It would apply a tax in 1986 through 1988 without regard to cash flow, income received or gain realized by the taxpayer in those years. In some cases, there may not be sufficient income to pay this tax. The real estate owner may be required to borrow funds to pay this unfair tax.

Second, the calculation of "excess depreciation" is erroneous. The use of the corporate "earnings and profits" definition of useful life (currently 40 years, straight line for structures) as an estimate of economic life to calculate the "excess depreciation" is inappropriate. As discussed below, the 3.5 percent rate and the 28-year recovery period provided by the proposed CCRS system are not accurate calculations of proper depreciation deductions for structures. This being so, a 40-year standard is even less appropriate for calculating "excess depreciation."

Third, the mechanism for recapturing the assumed excess depreciation would result in the collection of more revenue than can be justified. Also, the amount of unjustified recapture for real property is much higher than for all other assets. In a recent article by C. Clinton Stretch and Emil M. Sunley of the accounting firm Deloitte, Haskins & Sells,1/ the authors compared the amount of recapture under the exact theoretical method outlined in the President's proposal to the amount of recapture under the proposed rule. They concluded that for real property the proposed rule would be almost three times harsher than can be justified. For other assets, the proposed rule would be from 22 to 100 percent harsher than can be justified.

Fourth, it discriminates against investments in larger structures or in multiple smaller structures. Because of the $400,000 exemption and the exclusion of the first $300,000 of excess depreciation, this provision would only apply to larger structures, or to taxpayers with multiple smaller structures. Therefore, this additional tax would fall primarily on those who most effectively implemented the pro-investment policy of ACRS.

Fifth, the proposal is unfair in that it does not permit an adjustment of basis for the recaptured depreciation.

E. Depreciation

1. Current Law

The Accelerated Cost Recovery System (ACRS), enacted in 1981, provides an 18-year recovery period for new and existing commercial and residential structures, with deductions taken optionally by the straight-line or 175 percent declining-balance methods (except for low-income housing, which is depreciated over 15 years using the 200 percent declining-balance method). The basis of the property is not adjusted for inflation.

2. President's Proposal

The Capital Cost Recovery System (CCRS) would establish 6 classes of property with recovery periods ranging from 4 years for current 3-year property to 28 years for current 18-year property and 15-year low-income housing. Deductions initially would be taken under the declining-balance method on the inflation-adjusted basis of the property at a four percent-per-year real depreciation rate. Depreciation would shift to the straight-line method in the fourth year, when this method results in a greater deduction than the declining-balance method.

CCRS is supposed to reflect real economic depreciation patterns (a geometric decline in real value) and real depreciation rates (longer recovery periods), and provide some amount of investment incentive. Treasury would establish permanent facilities to study economic depreciation and would be authorized to reclassify an asset type that deviates significantly from the norm for its class.

CCRS would be effective for property placed in service after 1985. Anti-churning rules similar to those applicable to ACRS would be provided.

3. ICSC Position

ICSC supports the establishment of a depreciation system based on the principles in the President's proposal: (1) the cost recovery of the real (inflation adjusted) cost of depreciable assets; (2) cost recovery based on economic depreciation rates; (3) depreciation rates and recovery periods that produce investment incentives; and (4) effective tax rates that are equal for all asset classes. Unfortunately, the CCRS does not meet these standards as it applies to structures.

According to independent empirical and theoretical studies, it is based on an erroneously low calculation of the real economic depreciation rate and a high estimate of the cost recovery period for structures. It provides no investment incentive and it produces an effective tax rate for structures that is one-third higher than for all other classes of assets. While it properly adjusts the basis of depreciable property for inflation, and, thus, provides for "real" depreciation deductions, most shopping centers will not get depreciation allowances sufficient to allow them to recover their actual capital consumption costs. To meet the standards set forth by the President, the CCRS cost recovery period and depreciation rate for structures should be revised to provide for actual capital consumption, an investment incentive, and effective tax rates equal to all other asset classes.

4. Arguments

a. A Fair and Appropriate Adjustment For the Depreciation of Structures

Depreciation represents the reduction in value of an asset because of its use, aging or obsolescence. The tax laws recognize that at some point in the future the taxpayer will have to replace property that depreciates. For that reason they permit the owner of property used in trade or business or to produce income to deduct a certain amount from each year's income so that at the end of the asset's useful life the total of all the deductions will provide sufficient funds to replace the asset.

The new depreciation recovery system, the Capital Cost Recovery System (CCRS), proposed by the President is supposed to provide for: (1) the cost recovery of the real (inflation adjusted) cost of depreciable assets; (2) recovery based on economic depreciation rates; (3) depreciation rates and recovery periods that produce investment incentives; and (4) effective tax rates that are equal for all asset classes. ICSC supports such principles as the basis for a depreciation system, but CCRS does not meet these standards for structures.

The appropriate levels of capital consumption allowances and the appropriate cost recovery periods for depreciable property have been the subject of debate for many years among economists, the Treasury, the Congress, and taxpayers. Although, there is wide agreement that the variable effects of inflation should be removed to provide more certainty in investment decisions, there is substantial disagreement about the real economic lives of assets and their appropriate capital consumption cost recovery rates. This disagreement is caused in major part by the complexities of accounting for technological obsolescence, changing market conditions, different uses, and various amounts of risk. Also, there is considerable debate about the appropriate incentives to be provided through depreciation deductions to encourage investment in depreciable property.

While there is no dispositive empirical report or theoretical study on depreciation and both empirical and theoretical studies show a range of depreciation rates and recovery periods for structures, there are parameters outside of which estimates of depreciation recovery periods and rates are not seen as credible.

In this debate, the Treasury and the IRS, as collectors of revenue, have tended to take an extreme view on the low side of the proper deductions for the depreciation of structures. This extreme view has been expressed over the years in the administration of the tax law and in legislative proposals regarding depreciation.

In proposing the Real Cost Recovery System for structures of 3 percent after adjusting for inflation over a period in excess of 63 years in Treasury I and the Capital Cost Recovery System for structures of 3.5 percent after adjusting for inflation over 28 years in the President's proposal, the Treasury has continued its history of taking an extreme view on the low side of what is the appropriate composite depreciation adjustment for structures.

In determining an appropriate depreciation deduction for structures, Congress should keep in mind the Treasury's historical bias against adequate depreciation deductions for structures and should examine the empirical and theoretical studies which show that the President's proposal does not provide an adequate depreciation deduction for structures.

1. Rate of Depreciation For Structures

a. Flawed Basis For the Treasury Rate

The depreciation rates on which CCRS is based are derived from one flawed econometric study which was financed by Treasury and which comes to a conclusion about the appropriate depreciation deductions for structures that is at the extreme low end of the calculations of depreciation for structures made by other economists. This study, by Charles R. Hulten and Frank C. Wykoff,2/ concludes that structures depreciate geometrically (by a declining-balance method) at 3 percent-per-year.

Not only does this conclusion represent an extreme view, but the authors themselves disclaim the use to which their study has been put by the Treasury. Thus, Hulten and Wykoff, recognizing that the thrust of their study was methodological, stated: "We wish to emphasize at this point, that the numbers shown...are in no way intended to be definitive estimates of depreciation."

Also, the method used in the study to establish depreciation rates is flawed in several respects according to a recent article by Professors Edwin S. Mills and Harvey S. Rosen of Princeton University.3/ They cite as defects of the study the failure to consider technological advances in buildings systems; the failure to consider capital improvements; the use of an outdated 1935 study to estimate the withdrawal of structures from service; and the subjective estimate of the price of the structural component of the property caused by the respondents allocating the sale price between the structure and the land. Mills and Rosen conclude:

> Other studies using the same theoretical framework but different data and/or statistical methods might reach different conclusions. For example, Professor Alan Auerbach of the University of Pennsylvania recently estimated a geometric depreciation rate of 7.2% for structures, about twice that of Hulten and Wykoff. We are not necessarily convinced that Hulten and Wykoff are wrong and Auerbach is right. Both studies have their own virtues and their own problems. The point is that it may be imprudent to take the results of one particular econometric study and use them as the basis for an important policy change.

Thus, the study on which the Treasury bases their depreciation rate is seriously flawed and not designed to be used as such a measure. Also, another study by a respected economist calculates the appropriate depreciation rate at more than twice the Treasury rate.

b. Risk Premium

In their paper, Mills and Rosen discuss an article by Stanford Professor Jeremy Bulow and Harvard Professor Lawrence Summers[4] which states that capital asset values are volatile, that the tax system is biased against risky assets, and that this leads to a misallocation of resources in the economy. They conclude that a risk premium should be added to the economic depreciation rate, and note that studies of the risk premium for corporate capital as a whole indicate that the risk premium for such capital is 6 percent. Since the value of structures is more volatile than capital as a whole, Bulow and Summers believe that the risk premium for structures should be at least 6 percent.

c. Proper Depreciation Rate

If you accept the Treasury position that the depreciation rate for structures is Hulton and Wykoff's

3 percent, the addition of a risk premium of 6 percent will result in a total depreciation rate of 9 percent. If you take the position that the depreciation rate for structures is Auerbach's 7.2 percent, the addition of a risk premium will produce a total depreciation rate of 13.2 percent. Under either analysis the CCRS depreciation rate of 3.5 percent clearly is inadequate.

As Harvey S. Rosen points out in a recent analysis of CCRS:

> What can be concluded from the foregoing analysis about the appropriate depreciation formula? The honest answer is that available studies do not permit a firm conclusion about the depreciation formula that would achieve the Administration's goal of a tax system that avoids distortion in capital investment. However, my analysis leads me to believe that the Administration proposal of 3.5 percent of original cost for 28 years may well be inadequate. Quantitatively, the risk premium is probably the most important issue. The analysis in the previous section suggests that the appropriate geometric depreciation rate is probably not much less than twice the Hulten and Wykoff figure of 3%, and may be much more. For most kinds of real estate, the appropriate geometric real depreciation rate is probably between 6 and 11 percent per year. While the Administration's proposals are certainly not absurd, they appear to be decidedly on the low side.5/

2. Depreciation Period

As indicated above, there has been a longstanding debate between the Treasury and taxpayers about the appropriate cost recovery period for structures, and the Treasury has consistently taken an extreme position about the appropriate recovery period.

For example, an analysis of the regulations, cases, and the practices of building owners shows that under pre-ERTA law the depreciation periods for buildings advocated in the Treasury guidelines and IRS audits significantly exceeded the depreciable lives which generally were claimed by building owners and which generally were upheld by the courts.

Thus, in Rev. Proc. 62-21,6/ issued in 1962 and revoked for taxable years after 1970, the Treasury issued depreciation guidelines which listed useful lives of 40 to 50 years for most structures.

However, empirical studies showed useful lives substantially shorter than the guidelines. A study by Touche Ross & Co. for ICSC showed that in 1973 the range of depreciable lives claimed for most shopping centers and accepted by the IRS was from 22 to 29 years.7/ In 1975, the Treasury Department published in Business Building Statistics a study of the useful lives for various types of structures which showed that virtually all useful lives were shorter than those listed in the Treasury guidelines.8/

In The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals, the Treasury proposed new guideline lives of 30 to 40 years for office buildings, 35 years for factories, 30 to 35 years for retail buildings, 30 to 35 years for service buildings, and 30 to 35 years for residential buildings.9/ These guidelines do not take into account economic changes or technological and functional obsolescence or an incentive for investment.

According to our research, the CCRS 28-year recovery period for structures will not allow most shopping centers to recover their actual capital consumption costs. The 1973 Touche Ross & Co. study of depreciable lives of shopping centers determined that the range of shopping center useful lives (the distribution between the 30th and 70th percentiles) was 22 to 29 years. These lives are designed to recover historic capital consumption costs without inflation and do not include an investment incentive.

The study also concluded that in practice there was significant agreement between the taxpayers and the IRS on useful lives well below the Treasury guidelines when the IRS examined the specific facts and circumstances of individual shopping centers.

It appears that under CCRS most shopping centers will not get depreciation allowances sufficient to allow them to recover their actual capital cost consumption costs. This conclusion is based on the 22 to 29-year depreciation periods, without investment incentive generally claimed for shopping centers and accepted by the IRS under the facts and circumstances test prior to ACRS, and to the 15 and 18-year cost recovery periods under ACRS. Seen in this light, the CCRS period of 28 years is inadequate.

3. Investment Incentive

According to the President's proposal, CCRS is supposed to provide an investment incentive for structures as well as provide for the recovery of consumed capital. However, by our calculation CCRS provides no real investment incentive and provides substantially less investment incentive than ACRS. As a result, the adoption of CCRS will reduce investment in structures.

CCRS allowances for structures are about equal to 28-year straight-line depreciation, adjusted for inflation. For typical holding periods and forseeable inflation rates, the present value of CCRS depreciation deductions is substantially lower than the present value of deductions now available for 18-year, straight-line depreciation.

The President's proposal states that the present value of CCRS deductions is equal to 18-year, straight-line deductions when inflation is at least 5 percent. However, this assumes the property is held for 28 years. At a holding period of 15 years, an inflation rate of at least 12 percent-per-year is required for the present value of CCRS deductions to equal the present value of 18-year, straight-line deductions. For the present value of CCRS deductions to equal to present value of 18-year, accelerated deductions (175 percent declining balance), the inflation rate must be at least 23 percent-per-year.

Although it is difficult to compare the original Treasury proposal's 3 percent-per-year depreciation rate to the CCRS system's essentially 3.5 percent straight-line rate, it appears that the intended CCRS investment incentive for structures is 0.5 percent. In fact, this is no investment incentive at all.

4. Neutral Taxation of Asset Classes

At one point, the President's proposal states that CCRS will equalize effective tax rates across asset types. Yet at another point it states that the effective tax rate on investments in structures under CCRS would be about one-third higher than the effective tax rates applicable to investments in *all* other classes of assets. This unequal effective tax rate structure will continue the bias against structures and the resulting economic distortion that exists under ACRS and that existed before ACRS.

This higher effective tax rate for structures is further evidence that the depreciation rate for structures under CCRS is too low, that the investment incentive provided for structures is inadequate, and that no risk premium is included in the depreciation rate.

We believe that the depreciation rates under CCRS should be revised to *equalize* the effective tax rates for *all* asset classes.

5. Inflation Adjustment

The proposed CCRS cost recovery allowances are adjusted for inflation through the annual indexation of adjusted basis. This inflation adjustment will remove the variable effect of inflation on the real value of depreciation deductions. This will promote certainty in expected real rates of return on investments in depreciable property, and encourage investment in such property. ICSC strongly supports this feature of CCRS.

6. Conclusion

In determining the proper depreciation deductions for structures Congress should consider the range of theoretical and empirical studies regarding this issue and should not rely on the extreme and flawed recommendations of the Treasury.

Such a comparison shows that the 3.5 percent CCRS depreciation rate and the 28-year CCRS recovery period are not credible calculations of the depreciation rate and the depreciable lives of shopping centers. Most shopping centers will not get depreciable allowances sufficient to cover their actual capital consumption costs under CCRS.

Seen in this light, it is clear that the CCRS cost recovery period and depreciation rate for structures should be revised to provide for actual capital consumption, an investment incentive, and effective tax rates equal to all other asset classes.

Also, it is clear that even less beneficial measurements of depreciation deductions for structures, such as the straight-line 40-year recovery period for structures in the corporate earnings and profits test and the 3 percent rate and the 63-year recovery period for structures in the original Treasury tax reform proposal, should not be used as standards for the real economic depreciation of structures for the purpose of determining excess depreciation under the minimum tax or under the provision recapturing excess depreciation in the President's proposal.

F. Other Provisions Affecting Real Estate

In addition to the major issues discussed above, there are several other provisions of the President's proposal that are of concern to ICSC.

1. Minimum Tax

Both the individual and corporate minimum taxes would be revised to include as a preference item: (1) the excess of any accelerated depreciation over straight-line depreciation for property placed in service before 1986; and (2) the excess of the depreciation deductions taken under the new CCRS depreciation system (3.5 percent taken over a 28-year recovery period) over the amount that could have been taken under the depreciation system proposed in the November 1984 Treasury tax reform proposal (a 3 percent per year declining balance rate on an inflation-adjusted basis with a 63-year recovery period).

For the reasons stated above in the discussion of the President's depreciation proposal, ICSC objects to the use of either CCRS or the Treasury I proposal as a standard for measuring excess depreciation.

2. Construction-Period Interest

Real property contruction period interest is amortized over ten years under current law. The proposal would require it be amortized over the life of the property, 28 years. This would increase the cost of new construction.

3. Effective Dates, Transition Rules, and Grandfather Provisions

ICSC strongly believes that all significant tax changes should include prospective effective dates, transition rules, and grandfather provisions.

V. CONCLUSION

In conclusion, I would like to repeat that an overhaul of the federal tax system may be desirable if done properly. In order to assure that real estate development is not disrupted and penalized, the tax revision plan should be worked out in cooperation with industry representatives. ICSC is willing to work with Congress, the Treasury Department, and other industry representatives to assure that such changes would improve the operation of the real estate industry.

LINCOLN PROPERTY COMPANY

STATEMENT SUBMITTED TO THE COMMITTEE ON FINANCE - U.S. SENATE

RE: JULY 16, 1985 HEARINGS ON THE EFFECT OF THE PRESIDENT'S TAX PROPOSAL ON HOUSING AND REAL ESTATE

Overview

Lincoln Property Company (LPC) is considered the nation's largest developer of multi-family housing and the second largest U.S. developer of commercial properties. LPC is headquartered in Dallas, Texas and has offices in 20 different states.

Since inception of the Company in 1965 through December 31, 1984, Lincoln has developed 102,169 apartment units, 4,010 townhouse units, and 42,606,000 sq. ft. of commercial space in the U.S. with an aggregate cost put in place of $5.8 billion. These properties are located in 26 different states and 140 different cities.

Since release of the Treasury's proposal on tax reform in November 1984, and the President's proposal on tax reform released on May 29, 1985, we have attempted to analyze the effects of certain provisions on LPC's future development business. Because of LPC's financial strength and leadership position in the industry, we believe our Company will adapt to any tax reform measures enacted, even though it may mean a reduced volume of development activity for us. The proposed tax reform provisions make drastic changes in tax law affecting virtually every segment of the economy. These changes have been developed based on static analysis of these effects, while ignoring the dynamic and interdependent structure of a complex economic system. From our standpoint, we are concerned that certain measures aimed at the real estate industry will produce significant negative effects throughout the economy. The effects we are most concerned about are:

- Significant decline in construction activity, with a resultant shortage in rental housing and decreased employment in the construction industry and in the numerous industries related to construction and real estate.

- Decrease in real estate values, which may seriously jeopardize the financial condition of lenders and owners.

- Significant increase in rents, especially in apartment rents.

The specific tax proposals which individually, or in combination, would likely lead to these results are:

(1) Application of "at-risk" rules to real estate, without any exception for loans from institutional lenders.

(2) Treatment of a limited ner's distributive share of interest expense as investment interest.

(3) Treatment of all gain on sale of depreciable property as ordinary income.

(4) Inflation indexed depreciation - 28 year period for real property.

(5) Recapture of rate reduction benefit attributable to excess depreciation.

Projected Economic Effects - LPC and the U.S. Economy

The real estate industry is an important element of the U.S. economy. Real estate alone represented almost 12 per cent of GNP in 1984; the related industries of construction and finance combined with real estate were over 20 per cent of GNP.(1) In 1984, 47 per cent of gross private investment was in residential and non-residential structures.(2)

The real estate industry involves many types of business - brokers, appraisers, leasing agents, property managers as well as developers such as LPC. There are numerous industries that are directly and indirectly affected by the level of new real estate development or renovation, such as construction companies, architects and engineers, lumber, cement and other materials manufacturers, appliance and furniture manufacturers, lending institutions, title companies, law firms, accounting firms, maintenance/janitorial companies and landscape companies. In 1983, there were almost one million employees in the real estate industry, nearly 4 million employees in the construction industry, and approximately 5.5 million employees in the financial services industry.(3) In total, these employees make up over 10 percent of all workers in the U.S.

Lincoln Property Company, as one of the nation's largest real estate developers, projects construction of the following in 1985:

Units of Development		Cost
Residential (units)	12,500	$ 530,618,000
Commercial (sq.ft.)	11,100,000	1,343,744,000

Our projected development for 1986 will be significantly lower if all the President's proposals affecting real estate were enacted. In addition to the five proposals enumerated above, the President's proposal would eliminate the use of tax-exempt industrial development bonds for the construction of apartment units, including units targeted for low-income individuals. In the 1984-1985 period, Lincoln financed over 9,300 apartment units utilizing tax-exempt bond financing. Since the current market for multi-family housing financing is limited, our volume of apartment unit construction starts would necessarily decline due to this proposal alone. If the other five proposals are also enacted without modification, we estimate our annual construction starts for apartments could possibly decrease by 70 percent. This, of course, depends on the influence of many other factors, such as the market's ability to absorb rent rate increases, as well as interest rate and other financing changes which may result from tax reform.

Simply stated, the reasons for this decrease in construction starts are as follows. LPC traditionally finances virtually all of its construction of apartments (and a few commercial properties) by raising 20-30% of the cost through equity from individual limited partner investors and the remainder as debt from financial institutions. The limited partner investors must weigh their investment in our real estate partnerships against every other form of investment available. The federal income tax treatment of their investment is a factor in the rates of return they can expect to receive. In any real estate development, the start-up period, from inception until the property actually produces cash flow, is at least two to three years. The only return during those first few years is due to tax benefits. Without those tax benefits, investors would be unwilling to invest unless rents were increased. Thus, rents are currently much lower than would be necessary to support a competitive rate of return without certain current tax treatments.

As any apartment developer will confirm, multi-family housing is a type of investment that does not produce cash flow comparable to other real estate properties or some other investment opportunities. Congress has recognized this in the past by providing more favorable tax treatment to residential real estate. The President's proposal would eliminate all tax incentives to build multi-family housing.

In order to estimate the effect on apartment rental rates, we analyzed one of our typical apartment projects, a 204-unit complex currently under construction. The project was financed with 25% equity from limited partners and 75% debt. We calculated the effect on rents under inflation assumptions of zero to 8 percent. Tax reform proposals analyzed were:

- 35 per cent marginal individual income tax rate.
- At risk.
- Investment interest (both 10% and 100% phased in)
- CCRS/No capital gains exclusion.
- All four above (investment interest 100% phased in).

The attached Table 1 and Graph 1 show the resulting rental rate increases required under a 35% marginal individual income tax bracket.

Table 2 and Graph 2 show the results for a 50% marginal individual income tax bracket. Based on 5 per cent inflation, Table 1 (35% rate) shows that a 30 per cent increase in rent would be required to produce the same after-tax rate of return as under current tax law if all four proposals were enacted.

Some combination of the results discussed above would mean both higher rents and less new construction activity. Low and moderate income taxpayers, which overwhelmingly make up the nation's renters, may receive tax reductions in one hand which they must turn over to their landlords in the other. With less new construction and renovation of existing properties, a shortage of rental housing could likely occur until such time as increased rents could spur new construction. This would exacerbate the current shortage of apartment housing units which are available to renters with children and to renters at the lowest income levels. Many American families will find themselves in the midst of a rental housing shortage without the financial means to purchase their own home.

If these tax proposals are enacted without modification, we also expect the market value of existing properties to be adversely affected. Tax considerations are an important key in determining the market value of real estate, since any potential purchaser must look to an expected after-tax return on investment. A general devaluation in real estate properties would affect not only our investors but would have repercussions in many other areas. For example, if rent could not be increased enough (due to current leases in place or market demand) on a building to absorb the tax increases and provide the same rate of return, the market value of that building may fall well below the amount of mortgage debt. The effect of this on a wide scale would be defaults on mortgages, financial problems for lenders, and unemployment for workers directly and indirectly involved. A general devaluation of real estate would hurt millions of individual wage earners who invested their IRA contributions in real estate or whose employer pension plan assets were invested in real estate properties.

Discussion of Specific Tax Proposals

(1) At Risk - Real estate is an investment which has uniquely and traditionally been financed with non-recourse indebtedness since the property itself is the only collateral. Non-recourse financing is the commercial norm for real estate and is even required by several States' laws. The at-risk proposal would impose a penalty on real estate investment based on the method of financing. The Administration's tax reform proposals concerning real estate are based on the popular perception that real estate is a tax-favored investment and acquires even better benefits as a result of being highly leveraged. These are misconceptions because:

(a) Real estate commonly employs a high level of initial borrowing, but the debt/equity ratio declines over time. The average borrowing over the economic life of a real estate asset is typically no higher than for assets in other sectors.

(b) The financing of any asset with debt vs. equity does not affect the taxation on the gross income from the asset. When interest expense is fully deductible, the lender and the owner of real estate merely split the income produced by the asset.

(c) Real estate is now a relatively highly taxed asset (See Table 1, Page 156, Treasury I Volume 2) and becomes more unfavorably taxed under the President's proposals vis a vis other investments. Any increase in federal taxes on real estate would add to an already substantial burden of state and local real property taxes.

This proposal would prohibit many individuals from participating in real estate ownership because of the significant risks that would have to be assumed in order to receive fair tax treatment. In the future, the trend would be towards more ownership of real estate properties by corporations (which are not subject to the at-risk rules) since personal ownership would be prohibitive (In 1983 individuals owned 38 per cent of the $1.6 trillion of non-residential structures(5)).

We believe that the only valid application of the at-risk rules is to prevent artificial inflation of real estate prices in abusive situations. We propose that the Committee seriously consider a rule that would exclude non-recourse loans made by institutional lenders. Institutional lenders make loans based on economic, not tax considerations. This exception would allow real estate to remain on an equal footing with other investments, which by their economic nature generally cannot employ non-recourse financing methods.

(2) Investment Interest-Limited Partners - The President's proposal would extend the investment interest limitation rules to a limited partner's distributive share of interest expense from a partnership. We believe this proposal would also act to reduce investment in real estate by most individuals, since interest would only be fully deductible by

corporations or by wealthy individuals with large amounts of interest and dividend income. The proposal is unfair due to its retroactive nature. It would apply to investors who anticipated full deduction of interest expense when they made their original investment.

The concept of this proposal is flawed since interest on the debt incurred by an individual to acquire a building is generally fully deductible, while several individuals joining together in a limited partnership to acquire that same building could only deduct their share of interest expense equal to their net investment income. Coupled with the at-risk provision previously discussed, individual investors would have to accept substantially more risk by becoming general partners in order to receive the full deduction for expenses incurred to produce income which is fully taxed. It is our experience that the average real estate investor could not shoulder such risk, resulting in a shortage of equity capital. Again, the consequent result would be a reduction in construction activity, some shortages in rental housing, and increase in rental rates. We submit that this proposal should not be enacted.

(3) Gain on Sale of Depreciable Real Property Treated as Ordinary Income - The Administration proposes to deny preferential capital gain treatment to depreciable property used in a trade or business and tax the inflation adjusted gain at ordinary rates. We believe this provision puts depreciable real estate at a disadvantage to other investments, thus violating the stated goal of neutrality in the taxation of investments.

The capital gain deduction is an important incentive for savings, investment and capital formation. Changes in capital gain treatment can have lasting economic effects. This proposal would discourage the voluntary sale of depreciable real property. To the extent investors would be unwilling to sell their assets at an effective rate which could be substantially higher than the current rate, this provision would act as a restraint on the real estate market, interfering with otherwise free market forces.

Gains from the disposition of depreciable business property have been eligible for capital gain treatment since 1922 (except during World War II). This proposed selective discrimination reverses seven decades of tax treatment.

This provision would also adversely affect future investment in depreciable real property since real estate must compete with stocks and other financial investments, for which the capital gain preference is proposed to be retained. The uncertainty regarding ultimate tax rates would put real estate at a disadvantage to other investments in which tax treatment did not depend on predicting future inflation. This provision would also add another level of complexity to the labyrinth of tax laws.

We believe that depreciable real property used in a trade or business should continue to be eligible for the same tax treatment as land used in a trade or business and capital assets.

(4) Inflation Indexed, 28-Year Depreciation on Real Property - The President's proposal would replace ACRS treatment of structures with

CCRS. Under this system, most real property would be allowed a depreciation deduction set at approximately 3.5% of the initial cost after adjusting the basis for yearly inflation over a period of 28 years. We believe that ACRS has provided a valuable incentive to new business investment in the U.S. and has resulted in better long-term economic planning.

The Administration's proposed CCRS rules, which purport to introduce economic depreciation and which were based solely on one economic study, ignore all factors other than aging. Factors such as risk, type and usage of the structure, and capital improvements can also greatly affect the rate of economic depreciation, but are ignored in the study.

The CCRS proposal would substantially increase the effective tax rate for real estate, an asset which already carries a higher current tax rate than other investment such as machinery and equipment. The Treasury Department Report on tax reform (November 1984) showed that under current tax law the effective tax rate on real estate at 5 per cent inflation is 56 per cent compared to 26 per cent on equipment.(6) Without investment credit, the Report shows the effective tax rates on the two types of assets approximately equal under the current system. Replacing ACRS with CCRS would then result in a significantly higher effective tax rate on real property relative to equipment. Again, the concept of neutrality is violated, as is shown in the Administration's own studies regarding CCRS and real property.

LPC believes that this proposal alone would significantly raise rents, reduce new construction activity, and lower real property values. We propose that ACRS be retained or at least that other econometric studies be considered before structuring a new depreciation system.

(5) Excess Depreciation Recapture - The Administration proposes to include 1980-1985 excess depreciation, as defined, in income over a three-year period. This proposal's purpose is to prevent taxpayers from obtaining a theoretical windfall benefit due to the proposed reduction in tax rates. When applied to real property, the windfall benefit recapture is fundamentally flawed because:

(a) Under the current law, there is no depreciation recapture on real property which has been depreciated using the straight-line method. Individual taxpayers in this situation had the expectation of recognizing taxable gains at a maximum 20 per cent rate, not 50 per cent.

(b) The Administration's theory is that an asset depreciated in 1980-1985 reaches a "crossover" point during a time period when tax rates have been reduced. This "crossover" point is the time when a taxpayer is recognizing taxable income in excess of depreciation deductions. Because real estate is depreciated over a longer period (a minimum of 15/18 years under ACRS), the "crossover" point occurs much later than on other depreciable assets. The earliest a crossover point could be reached for an apartment building placed in service during 1980-1985 would be 10-12 years later, as much as 10 years later than this proposal would tax the windfall benefit.

(c) This provision also singles out depreciation and ignores other deferred tax liability situations (such as retirement/IRA contributions, installment sales, deferred compensation plans, completed contract accounting, etc.) which would also receive a theoretical windfall benefit from lowering the tax rate.

In addition, the proposal is an administrative nightmare. For regular corporations, the calculation of the excess depreciation is relatively easy compared to its calculation for millions of partners and S corporation shareholders individually for a five-year period. Members of partnerships and S corporations would bear a substantial administrative cost as a further penalty in addition to the recapture tax itself.

We believe that this provision, as applied to depreciable real property, is retroactive in nature, is unfair to real estate owners, and is theoretically unsound.

Transition Dates

Any tax reform enacted should also provide fair and appropriate transition dates. We believe that property under construction or subject to binding contracts before 1986 should be covered by existing tax rules.

Summary

Lincoln Property Company is extremely concerned about any drastic tax changes in the real estate area without consideration of resulting undesirable economic effects. We support the goals of fairness and neutrality in tax law and are concerned about the proliferation of abusive tax shelters. However, we also support the national goal of decent and affordable housing for everyone. Therefore, we urge the Committee to carefully consider the President's proposals since these changes could have a devastating effect on American workers and the U.S. economy.

Respectfully Submitted,

LINCOLN PROPERTY COMPANY

S. Joseph Barrett
Chief Financial Officer

NOTES

(1) Survey of Current Business, U.S. Dept. of Commerce, Bureau of Economic Analysis, April 1985, p 20.

(2) Survey of Current Business, U.S. Dept. of Commerce, Bureau of Economic Analysis, May 1985, p 7.

(3) 1985 Statistical Abstracts, p 414.

(5) Survey of Current Business, U.S. Dept. of Commerce, Bureau of Economic Analysis, August 1984, p 54.

(6) Tax Reform for Fairness, Simplicity, and Economic Growth, The Treasury Department Report to the President (November 1984). Volume 1, Table 6-4, p 110.

TABLE 1

PROJECTED RENTAL INCREASES
ASSUMING A 35% MAXIMUM INDIVIDUAL TAX RATE
(GRAPH 1)

PROPOSAL	ANTICIPATED INFLATION RATE								
	0%	1%	2%	3%	4%	5%	6%	7%	8%
35% MARGINAL RATE ONLY	6.05%	7.01%	8.62%	9.55%	10.60%	11.32%	11.57%	11.67%	11.70%
AT RISK ONLY	8.29%	11.06%	14.09%	15.88%	17.15%	17.91%	18.16%	18.23%	18.22%
INV. INT. ONLY (10% PHASED IN)	6.70%	7.92%	9.69%	10.80%	11.92%	12.65%	12.95%	13.10%	13.20%
INV. INT. ONLY (100% PHASED IN)	8.84%	11.88%	14.80%	16.52%	17.85%	18.83%	19.35%	19.75%	20.05%
CCRS/NO CAP. GAINS EXCLUSION	11.62%	16.46%	20.33%	22.47%	23.86%	24.64%	24.76%	24.63%	24.36%
ALL FOUR (INV INT 100% PHASED IN)	15.04%	20.67%	25.17%	27.53%	29.30%	30.40%	30.90%	31.14%	31.23%

GRAPH 1

REQUIRED RENT INCREASES

35% MARGINAL BRACKET

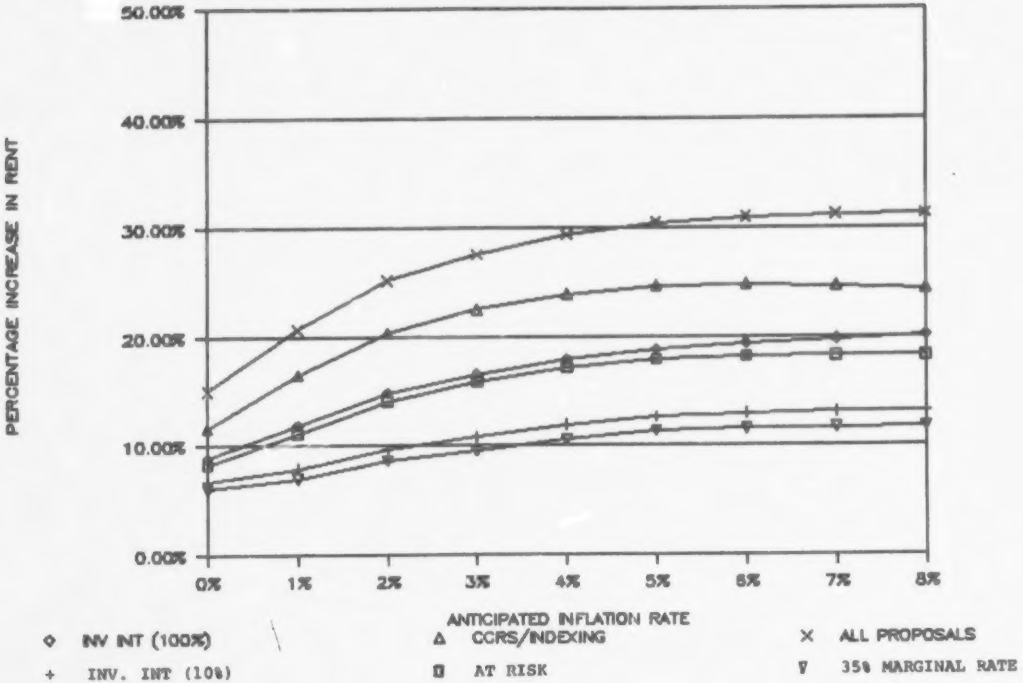

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TABLE 2

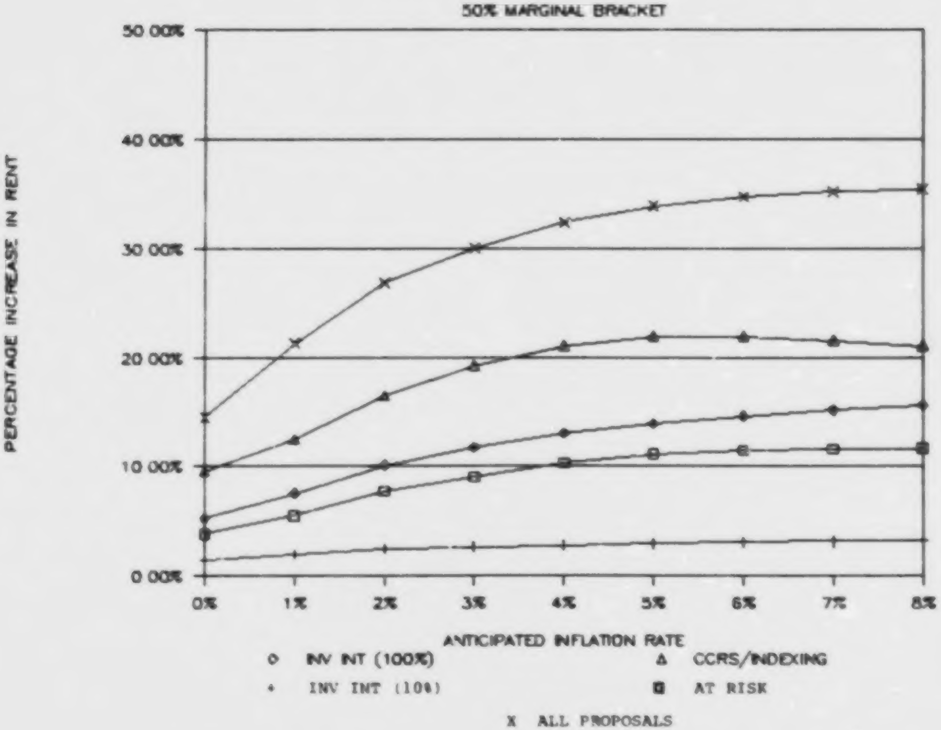
PROJECTED RENTAL INCREASES

ASSUMING A 50% MAXIMUM INDIVIDUAL TAX RATE

(GRAPH 2)

PROPOSAL	ANTICIPATED INFLATION RATE								
	0%	1%	2%	3%	4%	5%	6%	7%	8%
AT RISK ONLY	3.85%	5.54%	7.76%	9.04%	10.30%	11.16%	11.50%	11.61%	11.65%
INV. INT. ONLY (10% PHASED IN)	1.48%	2.00%	2.49%	2.67%	2.79%	2.95%	3.08%	3.20%	3.30%
INV. INT. ONLY (100% PHASED IN)	5.29%	7.54%	10.10%	11.70%	13.00%	13.93%	14.60%	15.15%	15.57%
CCRS/NO CAP. GAINS EXCLUSION	9.56%	12.50%	16.50%	19.24%	21.00%	21.90%	21.90%	21.55%	21.00%
ALL FOUR (INV INT 100% PHASED IN)	14.52%	21.28%	26.83%	30.00%	32.35%	33.88%	34.70%	35.16%	35.43%

GRAPH 2
REQUIRED RENT INCREASES



TREASURY II TAX PROPOSAL
Comments Regarding
Extend At-Risk Limitations to Real Estate

by

Minnesota Society of Certified Public Accountants
Committee on Federal and State Taxation

Authors: Dan Danielson, CPA
Michael V. Nelson, CPA
Norman R. Jones, CPA

July 1985

EXTEND AT-RISK LIMITATION TO REAL ESTATE

General Explanation

Chapter 13.02

The President's Proposal:

The at-risk rules would be extended to real estate activities. The at-risk rules would continue to be applicable to only individuals and certain activities of closely held corporations.

The President's Analysis:

The proper goals of the at-risk rules is to prevent taxpayers from sheltering income with artificial losses. The enactment of this proposal would place all limited partnerships on an equal basis (for the treatment of tax losses). This proposal would diminish the effectiveness of all real estate limited partnerships as tax shelters. Thus, reducing the effectiveness of some real estate limited partnerships as abusive tax shelters.

Our Analysis:

The enactment of this proposal has numerous adverse effects which cannot be ignored, viz., (1) increases in rents, (2) less low-income housing, (3) reduction in market values of existing buildings and (4) reduction in the demand for new construction.

The impact on the construction industry would be severe. Due to the reduced market prices for existing buildings, it would be less costly to maintain and/or acquire existing buildings than to start new construction projects. To this recession prone industry, the adverse impact could be the beginning of a new period of economic recession.

The greatest sacrifice will be required of those people least able to afford it. The adjustment to market pressures will be a rise in rents. To the lessees of commercial property, this will impose a significant burden. However, the increase of rents and/or the reduction of available low-income housing is an unconscionable burden to impose without some form of direct subsidy to assist the economically disadvantaged.

Our Proposal:

A direct subsidy should be enacted so that low-income housing rents remain stable. Despite the deficit problem, funds must be made available to replace this indirect subsidy to low-income housing. Such proposal must be tied to the tax reform to ensure that such proposed subsidy will not be overlooked in the overall federal budget considerations.

TREASURY II TAX PROPOSAL
INCREASE SPOUSAL INDIVIDUAL RETIREMENT ACCOUNT LIMIT

by

Minnesota Society of Certified Public Accountants
Committee on Federal and State Taxation

Authors: Norman R. Jones, CPA
David M. Senness, CPA
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July 1985

Chapter 14.01

The President's Proposal:

Married individuals filing a joint return, including individuals with no annual compensation, would be permitted to take into account their spouse's compensation in determining the deduction limit for contributions to an IRA.

The President's Analysis:

The proposed spousal compensation rule would permit certain married couples to set aside additional amounts in IRA's for long-term savings. This would enhance retirement security for such couples, and should also contribute to increased capital formation and productivity.

Our Analysis:

The tax benefits applicable to IRA's are intended to encourage individuals to make adequate provision for their retirement security. IRA's have the potential to be the release valve for the pressure on the social security system. The demands on Social Security have been far greater than planned, and the Social Security system has been greatly strained. Although a liberalization of the deductibility of IRA contributions would cause losses to general revenue, these losses can be offset by the future reduction or reduction in the increase of Social Security costs. These reductions can be effected by making the Social Security benefits a means tested benefit.

The IRA is an important element in the overall strategy to provide for retirement security. By increasing the emphasis on IRA's and thus, increasing the contribution limits, IRA's could become the cornerstone for retirement security. The use of IRA's for retirement savings should thus be encouraged by making contributions available on a broad and consistent basis.

STATEMENT OF

MORTGAGE BANKERS ASSOCIATION OF AMERICA

for submission to the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

on

THE IMPACT OF THE ADMINISTRATION'S TAX REFORM PLAN ON HOUSING, REAL ESTATE AND REHABILITATION

July 16, 1985

The Mortgage Bankers Association of America* submits this statement on the impact of the Administration's tax reform plan on housing, real estate and rehabilitation. *The President's Tax Reform Proposals to the Congress for Fairness, Simplicity and Growth* would broaden the base of taxable income and lower marginal tax rates.

MBA supports the overall thrust towards simplicity and fairness in the tax laws affecting the American people. MBA looks forward to working with the Administration and Congress on tax reform without losing sight of issues crucial to housing and real estate.

The President has said our tax system should reflect American values and should encourage investment and risk taking. These are the bulwarks of our economic system--our growth, innovation, and entrepreneurship. Homeownership and investment in real estate have long been regarded as integral parts of our national economic and social priorities and our tax system has reflected these goals. Investment and risk taking are of great concern to Americans, especially at a time when our economic growth appears to be slowing. Investing in real estate carries potential risk. Values rise and fall with business cycles. MBA believes that many of the provisions in the President's proposal could increase the after-tax cost of homeownership, could reduce the incentives to invest in rental housing and commercial real estate, and could lead to higher rents and lower property values.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

MBA has identified the following provisions of the tax proposals as most relevant to the housing and real estate finance industry and which would affect homeownership and investment in rental and commercial property. These are:

-- The restriction of full deductibility of mortgage interest expense to a principal residence.

-- The lowering of marginal tax rates.

-- The loss of the deduction for state and local real property taxes.

-- The limitation on the deduction of other interest expense to $5,000 plus net investment income.

-- The lengthening of the depreciation period for real property, including low-income housing, to 28 years.

-- The loss of capital gains tax treatment for real property subject to depreciation.

-- The extension of at-risk rules to real estate activities.

-- The loss of tax-exempt status for obligations of state or local governments where the proceeds are targeted to meet the multifamily housing needs of the low-income, the elderly, and the handicapped.

-- The loss of the tax credit for qualified expenditures incurred in connection with the rehabilitation of certain old or historic buildings.

-- The recapture of depreciation deductions taken on income-producing depreciable real estate from January 1, 1980, through June 30, 1986.

HOMEOWNERSHIP AS A NATIONAL PRIORITY

Homeownership has been the American dream as long as there has been an America. Throughout the history of our country, homeownership has been a national priority. It preceded the American revolution. The first European settlers established their homes on the coast of the new continent. When the newly formed nation pushed westward, the government promoted individual ownership of private property by homesteading acts.

When our country underwent urbanization and waves of immigrants landed on our shores, the concept of individual achievement and success as an American was the purchase of one's own home. For the last 50 years, as has been apparent in our housing programs and in our tax code, it has been an economic and social goal of our Federal government actively to foster the growth of homeownership. Decent and affordable housing for all Americans is one of the basic tenets of our democratic society.

Current Tax Law

From its inception, the tax code has recognized the importance of homeownership as a priority in the American value system. It has been tax policy to make homeownership affordable for as many Americans as possible. Purchasing a home is the biggest expenditure most Americans will ever make. The annual cost of owning a home is a large part of the budget of most Americans and is very sensitive to provisions in our tax laws. This has been the overriding reason for including provisions in the Internal Revenue Code which act as incentives to Americans to save for and purchase their own homes.

From the inception of the Federal income tax laws, the deductibility of home mortgage interest has enabled many Americans to buy and own homes. In addition to being able to deduct their home mortgage interest expenses, current tax law allows Americans to deduct state and local real property taxes from their adjusted gross income. This makes homeownership more available by reducing the effective cost of owning a home. Thus, by reducing the after-tax cost of homeownership, the tax code has enhanced the ability of Americans to afford their own homes.

THE PRESIDENT'S TAX PROPOSAL

The President's tax proposals focus on the lowering of marginal tax rates for individuals. In order to do this without losing revenue, the amount of income subject to taxation is increased in the proposal by the elimination or restriction of deductions, credits, and preferences. The President's tax reform proposal has been fostered by the general impression that the current tax code is unfair, overly complex, and a hindrance to economic growth. The impact of the changes embodied in this proposal will cause Americans to reevaluate their shelter decisions.

Lower Marginal Tax Rates and Repeal of Deductibility of State and Local Real Property Taxes

The following discussion is simply intended to analyze the impact of lower marginal tax rates and the repeal of the deductibility of state and local real property taxes, because these two provisions of the President's tax proposals would most directly impact the American homeowner. MBA's analysis indicates that these provisions would increase the after-tax cost of homeownership. Although mortgage interest paid on principal residences would remain fully deductible, the value of housing related deductions would be reduced. This would adversely affect the relative price of housing.

Let us be clear: MBA does not oppose lower marginal tax rates per se. We simply point out that the lowering of tax rates, when coupled with the elimination of the real property tax deduction, has the effect of increasing the after-tax cost of owning a home.

MBA's study reveals that the after-tax cost of owning a house increases in the 35 states included in the study, regardless of whether the state is a low- or high-tax state. (See attached Exhibit.)

MBA's study analyzed the impact of the reform proposals on the first year of homeownership for a married couple with two children filing a joint tax return in three income groups: $25,000, $50,000, and $100,000.

Average Increase in After-Tax Costs of Homeownership

Family Income	Yearly Pre-Tax Cost*	After-Tax Cost		Average Percent Increase
		Current	Proposal	
$ 25,000	$ 9,164	$ 7,583	$ 8,238	8.6%
$ 50,000	$14,536	$10,107	$11,999	18.6%
$100,000	$21,384	$13,619	$16,069	17.9%

*Includes mortgage payments, property taxes, and estimated utilities, maintenance and insurance costs.

No family income group in this analysis has its homeownership costs reduced by the President's tax proposals. Middle- and upper-income families experience the greatest increase in costs associated with the reduction of marginal tax rates and the repeal of the deductibility of real property taxes and therefore are the most adversely affected by the tax proposal.

Limitation on the Deduction of Interest

Under current law, there is a limitation on the deductibility of investment interest expense. Non-business interest expense currently is not subject to limitation. The tax proposal would expand the definition of investment interest to include non-business interest expense and would lower the amount allowed as a deduction. The expanded definition would bring in under the cap mortgage interest expense on a residence other than a principal residence and a limited partner's share of the limited partnership's interest expense. This means that mortgage interest expense other than for a principal residence would be subject to limitation for the first time in the history of the Internal Revenue Code. MBA believes that sales of homes other than principal residences could suffer and that property values at vacation areas could suffer. This limitation also could affect taxpayers with retirement homes. The potential decline in property values could have a negative effect for lenders if borrowers find their equity has been reduced.

The flat $5,000 limitation can be increased by the amount of a taxpayer's net investment income. This means that taxpayers with investment income would be able to deduct larger amounts of interest expense than taxpayers without investment income. Americans who have to borrow to finance their purchases would be penalized if they have interest deductions which exceed $5,000 and have no investment income to increase their allowable deductions.

MBA believes the deductibility of mortgage interest expense and real estate taxes on residences is consistent with this Nation's long-standing commitment to homeownership opportunities for all American families. MBA opposes any restrictions or limitations upon this deductibility.

In summary, while we support simplification and fairness in the tax system, we believe the proposals before us pursue these goals at the expense of housing. Because after-tax costs of housing will rise, most households, especially those with low and moderate incomes, will have no choice but to spend more of their incomes for housing, and thus have less for the other necessities of life.

INVESTMENT IN INCOME PRODUCING PROPERTY

Investment in real estate represents a major share of capital investment in the United States. It provides the land and structures for residential and non-residential purposes. It provides the facilities in which people live and carry on their businesses. The real estate industry itself is a major source of employment for Americans. In short, real estate activity provides homes, workplaces, and the places where we conduct commerce, where we shop, and where we enjoy our lives. Real estate investment comprises over one-fourth of all credit activity in the U.S. economy. According to the April 1985 Price Waterhouse study prepared for the National Realty Committee, it accounts for more than five million jobs and half of personal wealth and value of fixed capital in this country. Any changes affecting real estate made in tax laws must be scrutinized by policy makers, as they will have far-reaching effects on all sectors of the American ways of life.

The Lengthening of the Depreciation Period for Real Property

The proposed Capital Cost Recovery System (CCRS) would lengthen the depreciation recovery period to 28 years for real property, including low-income housing, and would index the unrecovered basis for inflation.

MBA believes that this change, one of a series of disruptive changes over the past several years, in the length of the depreciation period for real property is unwise. Numerous changes in depreciation periods have been enacted since 1981 and there is the possibility of yet another change as proposed by the recently passed imputed interest legislation.

Prior to 1981, depreciation deductions were allocated over the useful life of the property. The Economic Recovery Tax Act of 1981 eliminated this approach and replaced it with the Accelerated Cost Recovery System (ACRS), under which the cost of assets is recovered over predetermined recovery periods. The recovery period for real property from 1981 to 1984 was 15 years. The Deficit Reduction Act of 1984 increased the minimum real property recovery period to 18 years for property placed in service after March 15, 1984. The imputed interest bills recently passed by the House of Representatives and the Senate (HR 2475) propose to lengthen the recovery period again, effective May 9, 1985, from 18 years to 19 years. If tax reform legislation is passed, recovery periods would again be lengthened, perhaps to 28 years.

Since 1980, there has been repeated tinkering with depreciation deductions. MBA supports consistency and certainty in the tax treatment of capital cost recovery for real estate. In order to continue to attract investment capital, the recovery period should be a certain term of years and should remain stable over time. Real estate investment decisions require long-term planning and are enhanced by the ability to make long-term projections. The frequent changes for cost recovery in recent years from 30 years to 15 years to 18 years to 19 years to perhaps 28 years hampers the ability of lenders and investors to make sound and reliable long-term plans.

Furthermore, MBA believes that in a low and stable inflationary environment, it is unlikely that the indexation provision to adjust unrecovered basis for inflation will adequately compensate investors for the loss in cash-flow associated with the substantially longer write-off period.

MBA further points out that low-income housing will be especially disadvantaged under the President's tax proposal. Under present law, it retains the 15-year depreciation period even as the period for other real property has been lengthened to 18 years. MBA elaborates on low-income housing provisions on tax policy on page 14 of this statement.

Exclusion of Depreciable Property from Capital Gains Tax Treatment

MBA supports the continuation of appropriate capital gains tax rates for the sale or disposition of real estate. Such treatment attracts investment capital to construction and real estate development, which, in turn, contributes to a healthy economy.

One of the most devastating provisions in the President's tax proposals is the denial of capital gains tax treatment for depreciable assets, which includes rental real property used in a taxpayer's trade or business. Such treatment for long-term gains from sales or dispositions of investment property has been a major feature of the Federal income tax code for decades. To single out depreciable property for denial of capital gains tax treatment discriminates against real estate. By singling out one sector of the economy--depreciable property--for selective harsh treatment, the President does the opposite of what he promised. It makes the proposal unfair.

The top effective tax rate for capital gains on depreciable real property would increase from the current 20 percent to 35 percent. Non-depreciable capital assets, such as stocks and bonds, would receive a 50 percent exclusion for a top effective rate of 17.5 percent. MBA believes that investments in income real property would be at a competitive disadvantage vis-a-vis other capital assets. MBA believes that the capital gains differential plays an important role in savings and investment decisions and in capital formation. Investment activity in income real properties could decline due to the loss of preferential capital gains treatment combined with the proposed less generous depreciation rules. The real estate market could be "locked in" by the increase in the rate of tax on gains because investors would be reluctant to sell their assets at a rate nearly double the current tax rate.

One of the purposes of capital gains treatment is to attract capital to investments in which risk is involved. History has proven that the availability of investment capital is directly related to the level of capital gains tax rates. When top effective capital gains rates were 49 percent in the early 1970s, real estate experienced one of its worst recessions in recent history. According to a recent National Realty Committee analysis, with each decrease of capital gains tax rates, investment has increased. Federal revenues from capital gains taxes increased by $3.6 billion when the rate was reduced to 28 percent in the late 1970s.

Extension of the At-Risk Rules to Real Estate Activities

MBA supports the continued exclusion of real property from the application of the at-risk rules.

Imposition of the "at risk" rules on real estate transactions will dramatically alter long standing real estate market forces. The tax code has not been the incentive for non-recourse financing of commercial real estate. Investments have traditionally been without recourse with the real property as the specified security. This market practice has always been independent of the tax code and is attributable to the secured nature of the real estate market.

Mortgage lenders base their determination to make a non-recourse real estate loan on a number of factors. Their decision is based on the value of the asset and whether its income stream indicates a probability of return of principal and whether the interest rate is competitive and compensates the lender for the risk involved in making the loan.

MBA believes it is unwise to change the character of investment in commercial property. Middle-income investors would be eliminated from the market because they could not share the risk of loss from investments for which they would have to be personally liable in order to participate in the investment. This would be analogous to the impact of the now-defunct proposal to tax limited partnerships with more than 35 limited partners as corporations. It would allow only wealthy individuals to invest in the real estate market and would preclude many other investors from participating in real estate investment. This would impede capital formation.

Effect on Real Estate Capital Values

Capital values will likely suffer under three key provisions--lengthening the depreciation period for real property, eliminating preferential capital gains tax treatment for depreciable real property, and the extension of the at-risk rules to real estate activities.

If property values are adversely affected, the principal amount of existing mortgages could exceed the values of the underlying properties. When mortgage loan-to-value ratios are high, the risk of default increases. The investors' equity in the properties will have disappeared and along with it the incentive to keep investing more money in those properties. This is especially true in periods of low inflation when property values have little or no expectation of appreciation and investors see scant prospects for returns on investment.

Recapture of Depreciation Deductions

MBA is greatly concerned about the provision that would require taxpayers with total depreciation deductions of $400,000 for the six-year period 1980 to 1985 to include in their income over a three-year period, 1986 to 1988, 40 percent of the difference between depreciation deductions allowed under straight-line and accelerated depreciation for property placed into service between January 1, 1980 and December 31, 1985, for which depreciation deductions are allowable under current law for any part of the period January 1, 1980 through June 30, 1986. MBA believes that such a provision in a tax proposal for fairness and simplicity is both unfair and complex. For real estate it is a tax on a non-taxable event. For long-lived assets the crossover point could be further in the future than the 1986-1988 period, yet the "expected" deferred tax liability has to be paid before that time. In that case, it is a tax on money the taxpayer has not received. In addition, the recapture provision discriminates against depreciable real property by denying it the marginal rate reduction for three years while allowing owners of other kinds of income property, such as land and fixed-income debt obligations, the full benefit of lower rates.

The Repeal of the Tax Credit for Qualified Rehabilitation Expenditures

MBA supports Federal tax incentives aimed at encouraging the rehabilitation of historically designated income producing properties. MBA believes that the rehabilitation and preservation of historic structures is an important national goal. Federal tax incentives represent a needed incentive to the private sector to meet this goal.

MBA believes the rehabilitation tax credit is an incentive to investors to renovate older, existing properties for income producing purposes. MBA agrees with the intent of Congress to spur urban revitalization when it enacted credits for rehabilitation expenditures. According to the Department of the Interior Preservation Assistance Division, the 1976 tax incentives have stimulated considerable private investment in historic preservation. Since 1976, 60,000 housing units have been involved in the rehabilitation process, including the creation of 32,000 new housing units. Of these units 14,000 were for low- and moderate-income families. Sixty-five percent of the owners of certified rehabilitations indicated that they would not have done the rehabilitation work if the tax credit had not been available.

Repeal of Tax-Exempt Status of Mortgage Revenue Bonds

MBA urges that the Federal income tax exemption on revenue bonds for financing private industrial income-producing facilities be eliminated, except where such financing is used to meet city, state, or Federal environmental requirements, or is used to finance federally or state assisted single- and multi-family housing that is targeted toward meeting the needs of the disadvantaged, specifically the low income, the elderly, and the handicapped.

These bonds are extremely important in generating new multifamily construction, which is direly needed in many localities, particularly since Federal assistance for subsidized multifamily housing has been virtually eliminated.

Approximately one-quarter of the multifamily units started in 1984 were financed by tax-exempt multifamily revenue bonds (MRBs). In addition to these 113,000 new rental apartments, MRBs produced 26,000 units of substantially rehabilitated rental housing.

MRBs can provide significant decreases in the cash cost and total cost of owning a home. According to a soon-to-be-released study, a 2 percent reduction in the mortgage interest rate, from 13 to 11 percent for a level payment mortgage, would reduce total homeownership costs by 13 percent.

MBA supports tax-exempt financing for housing as long as it is targeted to the low-income, the elderly, and the handicapped.

Low-Income Housing

MBA believes that the President's tax proposal would virtually preclude investment in low-income rental housing. Under the current law, low-income housing is depreciated over 15 years, as opposed to 18 years for other income property. Under the proposed CCRS, the recovery period for low-income housing would be 28 years, the same as for other real property, and therefore would lose an attractive incentive for investors. In addition, taxpayers who invest in the rehabilitation of low-income rental housing would lose their election to amortize their rehabilitation expenditures over a five-year period.

MBA believes that the repeal of these incentives combined with the extension of the at-risk rules to real estate transactions and the loss of favorable capital gains treatment, will discourage investment in low-income housing. Low-income housing also could not be financed with tax-exempt bonds under the proposal.

MBA believes that the elimination of these incentives will cause rents to rise over the next three to four years to compensate investors for the reduced cash flow attributable to the loss of tax benefits.

Preliminary findings of studies that are underway indicate that the proposed changes in the tax treatment of investment in conventionally financed rental housing, the removal of tax incentives for investment in low-income housing, and the repeal of the tax-exempt status of MRBs will eliminate the production of the 25 percent of rental units that are financed at below-market interest rates. The increase in capital costs of these projects will lead to a large reduction in investment in such projects and a decline in construction. Findings indicate that the decline in the number of new rental units and the increased demand for rental housing will increase average rents by more than 20 percent over levels. Even slight rent increases are likely to offset any gains which low- and moderate-income households may have as a result of the proposed tax cuts. A two-earner couple with an annual income of less than $25,000 may have a tax cut of $100 a year. Even a small rent increase would offset that tax cut.

CONCLUSION

The President's comprehensive tax reform proposals eliminate or restrict tax deductions, credits, and preferences in order to lower individual tax rates on the grounds that the tax system will be fairer and that individuals will have more after-tax dollars for investment. Yet the evidence from the 1981 tax cut is that individuals did not save and invest the additional dollars. MBA believes that reducing the Federal deficit is the path to economic growth. The Federal government is competing with the private sector in the capital market for investment dollars. If those dollars were invested in the private sector rather than in the Federal government, we would have the economic growth the President wants and the Nation needs.

Also, because of MBA's deep concern over the Federal budget deficit, we raise another issue: whether the tax proposal is revenue-neutral. Treasury Secretary James Baker has said that tax reform legislation which either loses or gains $47 billion over five years would be viewed as revenue-neutral by the Administration. The Senate and House Budget Committees have spent months trying to agree on spending cuts of $56 billion. Given the magnitude of solving the budget deficit problem, a tax reform proposal that carries the possibility of an increased $47 billion budget deficit over five years should receive the very closest scrutiny by Congress.

MBA would also like to point out its concerns over the mismatch of effective dates for broadening the taxable income base (January 1, 1986) and for lowering marginal tax rates (July 1, 1986). This has a twofold effect. A larger tax base will be taxed at current rates for one-half of 1986, which cuts in half for 1986 the potential tax benefit associated with lower marginal tax rates. In addition, the opportunity arises for those who can afford to do so to defer income to the second half of 1986, when tax rates would be lower.

This is only one of several provisions that appears not to be fair or simple. Many of the provisions, such as denial of capital gains treatment for depreciable real property and the recapture of depreciation deductions, do not live up to the stated goals of tax reform: fairness and simplicity.

MBA encourages Congress to scrutinize carefully the President's tax proposals as well as Congress' own proposals, because a careful analysis of the Internal Revenue Code is long overdue. While engaging in this analysis, however, MBA urges Congress not to lose sight of the important social purpose of adequate housing that is currently encouraged by a variety of provisions embodied in the present tax code.

MBA appreciates this opportunity to present its views and would be happy to provide additional information if necessary.

NAA
NATIONAL
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ASSOCIATION

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TESTIMONY

of

ROGER GREER

on behalf of the

NATIONAL APARTMENT ASSOCIATION

before the

COMMITTEE ON FINANCE

U.S. SENATE

on

THE IMPACT OF TAX REFORM ON REAL ESTATE

July 16, 1985

Mr. Chairman and Members of the Senate Finance Committee, my name is Roger Greer and I am President of the National Apartment Association.* I am also President of the Texas Division of Johnstown American Companies in Houston, Texas, a full service real estate company. I appreciate the opportunity to present the views of the NAA concerning the impact of the President's "so-called" tax reform proposal on the rental housing industry.

We have no doubt that the proposal would severely injure our industry. The President's tax proposal will stop the production of rental housing, drive up rents, cause further deterioration of existing housing stock and force the private sector out of the rental housing market. As a result of the changes proposed, the Administration has signaled that decent affordable housing is no longer a national goal. Direct government assistance for housing has virtually been wiped out. Now, the incentives for private industry to produce and maintain existing rental housing would be repealed.

When the Treasury Department's tax reform proposal was released in November 1984, the NAA commissioned a study to assess the impact of the proposed changes in the tax code on the rental housing industry. This study (which did not consider the at risk and interest cap provisions) showed that rents would have to increase by 44 percent to make up for the loss of tax incentives as proposed in Treasury I.

When the President presented his tax reform proposal in May, our economist analyzed the provisions using the same model used to evaluate Treasury I. Although the President's plan is not as harmful as the Treasury I proposal, the President's plan would have a devastating impact on the multihousing industry. Our study of the President's proposal shows that rents must increase 18 percent in order to offset the tax changes. For the average renter, rents will go up from $350 to over $410 per month while the average tax savings would be in the range of $7 to $15 per month, or $84 to $180 per year.

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*The National Apartment Association is a trade association representing over 200,000 multifamily professionals including owners, developers, managers and industry suppliers of over three million rental units and condominiums nationwide. The NAA is headquartered at 1101 14th Street, N.W., Suite 804, Washington, D.C. 20005.

The economic analyses commissioned by NAA focused on several of the provisions in the President's proposal:

- The lengthening of depreciation schedules
- The application of the at risk rules to real estate
- The limitation of the deduction of interest expense
- The repeal of the capital gains exclusion for structures
- The repeal of the 10-year amortization of construction period interest and taxes, and
- The change in marginal tax rates

The following is a summary of the major effects on the rental housing industry if these provisions in the President's proposal are adopted:

- To maintain the current yield for investments in multifamily property, rents on properties would have to increase by more than 18 percent on properties that are constructed after enactment of the President's proposal.

- Investor/owners could experience declines in the value of their holdings by more than 15 percent unless rents increase significantly above inflation.

- New production of rental housing would decline sharply resulting in a housing shortage.

- In those particular developments where higher rents cannot be charged, the construction or rehabilitation of multifamily housing will not take place. The resulting shortage of housing will eventually drive rents up. Private industry will not be able to produce affordable, decent rental housing; particularly for those in income brackets that are least able to afford it.

- The lowering of the tax brackets and the expected lower tax for rental household families would be quickly absorbed by rent increases; thereby leaving renter households with less money for non-housing expenditures.

- The decline in rental real estate values could have a significant negative impact on loan to value ratios. This would increase the risk to the current portfolio of lenders who have invested heavily in apartments since the early

1980's when lending institutions were deregulated.

Although our studies show that rents would have to increase dramatically, it is doubtful that they would. Two market forces act to restrict increases in rent levels. The first is the income level of renter households. According to the U.S. Housing Survey, 1983, the median renter household income was approximately $13,400. These people cannot afford to pay higher rents.

Renters represent about 35 percent of all households in America. This translates to approximately 30 million households who choose to rent or find it necessary to rent in order to meet their shelter needs. The typical renter household devotes approximately 30 percent of its income to housing as compared to an owner household that devotes 18 percent of its income to housing and has a median income of $24,400. In 1983, 11 million renter households, or 37.5 percent of renter households had incomes below $10,000. Their median gross rent as a percentage of income was 56 percent. On average, households with income under $10,000 spent over one half of their income for housing.

The limited income is the principal reason that renter households spend a disproportionate share of their income for housing. Table I gives the latest available data for household income groups and their housing expenses as a share of income by tenure.

To the extent the tax incentives are repealed, rental income will have to increase to make up the shortfall in the rate of return. Consider the following example -- it is estimated that a married couple with an income of $25,000 would save $100 per year in taxes or, $8.00 per month. Assuming market forces would allow for only a ten percent increase in rent on a $350 per month apartment, the increase would be $420 per year or, $35.00 per month. This household's net cash position would be worse, and their tax savings would be absorbed within three months by rent increases. Clearly, tax reform will not benefit this renter household when all the costs and savings are tallied.

A second market factor that restricts rent increases is the favorable tax treatment of single-family housing. To a large extent, rents are limited by the minimum price of ownership housing with its tax advantage of the mortgage interest deduction, irrespective of the costs of providing rental housing. The President's proposal creates an imbalance between the two different sectors of the shelter industry. The homeowner sector retains most of its tax subsidies, the mortgage interest deduction and the nontaxable "imputed" value of rent. At the same time, the renter sector loses essentially all of its tax incentives.

The subsidy in the tax code for shelter is tilted away from those in need toward those with the highest income and most expensive shelter.

With rent levels restricted by the income of the poor and the ability of the upper bracket residents to buy, our industry must operate within narrow boundaries. The rental income plus the expected capital appreciation of the property do not provide an adequate return to investors. The incentives provided by the tax code make the difference when the decision to build or not to build is made. In other words, the tax incentives allow rents to be more affordable. Without tax incentives there will be a halt in multifamily housing construction and abandonment of rehabilitation. Only those complexes where sufficient rents could be charged would be constructed. Housing in low-and-moderate income communities would suffer.

The multifamily rental industry not only competes with the single-family industry, but it must compete with commercial real estate for investment capital. Because we are in the business of providing housing, the Committee must make a policy decision; whether to continue to give some tax advantages to multifamily housing. Commercial properties generally have a greater ability to raise rents because commercial tenants can pass through their costs. In multifamily housing we are dealing with the ultimate consumer -- the lowest-income Americans -- who cannot absorb rent increases without lowering their standard of living.

The tax code has provided additional incentives to housing in the past. Depreciation schedules prior to 1981 as well as under the Economic Recovery Tax Act (ERTA) were more favorable to housing. Faster schedules and more lenient recapture rules were permitted. We urge Congress to recognize the special needs and problems that the multifamily rental industry has.

Decent affordable housing has been a national goal. This country has and will continue to assist the poorest segments of our population by providing food, shelter and medical care. These are basic needs. As an industry spokesman with experience in the private sector of the housing industry, I can assure you that the private industry can build and operate an apartment complex much more efficiently than the government. On an average, private industry can build an apartment unit for $30,000. The cost, when government does it, rises to $50,000-60,000 per unit. Assuming this country will continue helping to house our poorest people, consider the cost of using tax incentives to produce housing versus direct subsidies. The cost to the government is far less when private industry produces the housing for our citizens.

Mr. Chairman, political realities have forced the housing industry to look to the tax code as the vehicle for providing the assistance we need so that affordable housing can be available for Americans. Direct appropriation programs, especially for our poorest income households, will always be necessary. "Tax shelters" are not just loopholes for the wealthy to avoid paying taxes. Instead, these "shelters" make it possible to build and rehabilitate housing for low-and-moderate income Americans that would be economically impossible without tax incentives provided through the tax code. These tax incentives, including the Accelerated Cost Recovery System (ACRS) of depreciation, the full deductibility of interest expenses, the non-applicability of the at risk rules to real estate and the use of tax-exempt housing bonds have been the lifeblood of our industry. The preservation of these tax incentives is essential to ensure that affordable rental housing will continue to be produced by the private sector.

In addition to the concerns about housing, the economic impact that our industry has on the economy should not be overlooked.

If the current tax laws remain intact, an estimated 500,000 units will be added annually to the rental stock in the decade of the 1980s. The construction of 450,000 multifamily rental units last year produced about 371,000 man years employment for workers in the construction industry. These workers earned $7.7 billion in wages and salaries in 1984. Multifamily rental construction annually accounts for the generation of $1.1 billion of federal, state and local taxes.

In addition to construction, in 1983, the rental housing industry generated $74 billion (excluding new construction) or 2.2 percent of the Gross National Product. The rental housing industry employs approximately one million full-time employees (excluding construction).

If the President's proposal was adopted, the reduced investment in multifamily construction would cause a tremendous loss of jobs, economic production in construction industry and in the industries that supply the housing industry. It would also lead to housing shortages in the near future.

NAA agrees that every industry must pay its share in attacking the Federal deficit. However, we feel the real estate industry is paying a disproportionate share of the burden. In fact, the President's tax reform proposal released in May contains provisions which, if enacted into law, would substantially alter how we, in the multihousing industry, will supply rental housing for this country. Under the proposal, the major changes which would impact real estate are the following:

DEPRECIATION

The current depreciation schedule for real estate would be repealed. Instead, the basis of depreciable assets would be indexed for inflation and depreciation allowances for tax purposes would be set at four percent per year with a close out in 28 years. This is a drastic change from current law. It also puts real estate in a worse position than it was prior to the Economic Recovery Tax Act (ERTA) of 1981. Prior to ERTA, buildings could be depreciated over an 18 to 25 year period using component depreciation. The President's proposal would also prohibit accelerated depreciation schedules which serve to attract investment capital by providing greater deductions in the early years.

According to our analysis, the change in depreciation schedule from ACRS to the Capital Cost Recovery System (CCRS) would have the effect of requiring rents to increase by 9.8 percent.

INTEREST EXPENSE

The President's proposal would place a cap on deductions for interest expense of $5,000 plus investment interest income. With regard to the interests of multifamily housing, this cap would apply to the limited partner's share of interest expenses of the limited partnership. It should be noted that the non-business interest expense for the principal home mortgage remains fully deductible.

The real estate industry relies on borrowing a significant portion of the purchase price of the property. It is common to borrow up to 80 percent of the proceeds under a long-term debt agreement. Lenders are willing to allow loans to value ratios of 80 percent because they have the security of the real property. Because high leverage is the norm in real estate transactions, the $5,000 interest cap is especially harmful to the industry. If borrowing is restricted and more equity is required, greater rates of return will also be required. This will place further upward pressure on rents.

This provision treats the debt expense of a limited partner as if it was not a business expense. This type of treatment ignores the risk involved in real estate investments by limited as well as general partners.

AT RISK RULES

The President's proposal would apply the at risk rules to real estate. This is a false solution to problems that involve over-evaluation of the property.

The at risk rules were originated to prevent the use of phony non-recourse debt to artificially inflate the basis of property thereby inflating depreciation deductions and the investment tax credit. Real estate has traditionally used non-recourse financing for reasons that are not tax motivated. Lenders are willing to accept only the assets as security for the debt. Certainly, there is no incentive on the lender's part to lend more than the security is worth.

Non-recourse financing serves to reduce some of the risk of the borrowers who invest in real estate. Because of the large amounts of money and debt, investor/borrowers cannot afford to be personally liable for the entire debt.

The application of the at risk rules is not an appropriate response to alleged problems related to over-valuation of property. Personal liability for the mortgage will increase the risk of the investment. Greater risks will demand greater returns. The result will be the reduction of housing production to the most secure, expensive developments.

RECAPTURE OF DEPRECIATION

The President's proposal would recapture as income 40 percent of certain depreciation expenses taken pursuant to ACRS schedules. To the extent ACRS expenses were taken between 1980 and 1986, the excess over a 40 year straight-line depreciation schedule would be subject to this new recapture tax. The recapture tax would apply whether or not there is a sale of the property. This penalizes investment in improved real estate and capital equipment -- the very things that have increased our productivity and capital base.

This is retroactive legislation. It unfairly penalizes industry that played by the rules. It causes a breach of faith with the business community because we acted in accordance with Congress' and the President's wishes only to be "burned" for doing so. The NAA strongly opposes this provision.

TAX-EXEMPT HOUSING BONDS

In today's high interest rate environment, tax-exempt bond financing is an essential tool to reduce the debt service sufficiently to make the transaction "pencil out." It is estimated that 50 percent of the multifamily housing production in 1982 used tax-exempt financing. In 1983 and 1984 that figure was in the 22 to 24 percent range. Without the ability to reduce the debt service expense by 200 to 300 basis points, many of those apartment developments would not have been built. The prohibition of the use of tax-exempt financing for multifamily housing would curtail production. Because of the low-income set-aside requirements to obtain bond financing, the greatest impact would be on the residents who can least afford it.

CAPITAL GAINS TAX

The President's proposal would deny the long-term capital gains treatment to assets that are depreciable. With regard to real estate, gains on the sale of land would be entitled to a 50 percent exclusion, but the structures would not be. The basis of the structure would be adjusted for inflation each year.

Long-term capital investments should receive special tax treatment in order to encourage those investments. Improved real estate is a long-term investment. It also involves a great deal of risk, therefore, the capital gain exclusion should apply to structures as well as land, stocks and bonds. It seems counterproductive to give special tax treatment to speculative investments in stocks, while placing the full brunt of taxation on the real estate and construction industries which create jobs throughout the economy.

HISTORIC AND REHABILITATION CREDITS

The proposed repeal of the historic and rehabilitation credits would have a significant impact on those urban areas that are trying to take advantage of their existing infrastructure. To the degree society wishes to preserve historic structures, to rejuvenate inner cities and rehabilitate existing housing stock, this credit should be retained.

RAPID AMORTIZATION OF COSTS

There are two provisions that currently allow the rapid amortization of certain expenses that encourage construction and rehabilitation of real estate which would be repealed under the President's proposal. The repeal of the ten year amortization of construction period interest and taxes would require that these expenses be amortized over the life of the building -- 28 years. The President's proposal would also repeal the five year amortization of low-income rehabilitation expenses.

The shortened amortization period provides an incentive to build and to rehabilitate. Although these items do not have large dollar value impacts, they enhance our industry's case that real estate is bearing an excessive burden of the so-called tax reform effort.

In light of our national priority to provide decent and affordable housing to all Americans, NAA urges Congress to preserve the tax incentives for capital formation in the multihousing industry in any overhaul of the current tax system. These incentives have kept the industry alive and have helped make the United States the best-housed nation in the world. They should be preserved and strengthened.

Private capital formation is essential to economic growth. The multihousing industry had just begun to reap the benefits of the positive changes enacted by Congress in 1981. The Economic Recovery Tax Act of 1981 provided some security to the rental housing industry by creating tax incentives which were designed to stimulate the economy. However, since that time Congress has consistently taken away these incentives through the Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984. The trend seems to be to focus on the real estate industry to make it bear an overwhelming and unfair portion of the burden of repaying the Federal deficit.

Critics focus on the high returns received by successful real estate ventures, but capital investment in real estate is very risky. This risk is often forgotten because failures in real estate are not newsworthy unless a whole state's saving and loan industry is imperiled by "risky" real estate investments as happened in Maryland.

In the multifamily area there are very unique risks including political interference with rights of ownership such as rent control, local taxation at discriminatory rates, substantial tax preferences for ownership housing and bankruptcy laws that treat rents differently than other debts. Because renters cannot afford rents sufficient to generate a rate of return commensurate with the risk of the investment, tax incentives are necessary. The alternative is for the government to spend billions for direct housing subsidies.

Frequent modifications of the tax code create uncertainty in the market and prevent long-term planning, an integral component of real estate investing. Furthermore, since the return on investments in rental housing is diminishing due to increasing maintenance costs and other factors, investors will begin to look elsewhere for investments that are more fruitful and more secure. The rental housing industry cannot withstand and survive continued changes in the tax code which draw more and more potential capital away from the industry.

Mr. Chairman, the rental housing industry has already begun to feel the effects of the Administration's tax reform proposal. Our members across the country have witnessed an increasing loss in the vitality in the industry under the shadow of further detrimental changes to the tax code. On behalf of the National Apartment Association and also of the residents we serve, I urge the Committee to examine and recognize the impact of each of the provisions in the President's "so-called" tax reform proposal and to work to preserve the essential tax incentives which have been the mainstay of the industry.

The NAA would be pleased to offer our assistance in establishing a coherent effort to assure that any tax reform package which may come before the Congress actually promotes fairness, simplicity and economic growth.

Mr. Chairman and Members of the Committee, I thank you for allowing me the opportunity to express our views. I would be happy to answer any questions which you have at this time.

TABLE I
Household Income and Median Housing Expenses as a Percent of Household Income (1983) Renter versus Owner Households

	Renters		Owners	
Income	% of total	median gross rent as a % of income	% of total	median housing expenses as % of income
10,000	37.5	56	13.0	41
10-14,999	18.2	32	9.4	24
15-19,999	13.6	26	9.3	29
20-24,999	9.5	21	9.8	20
25-34,999	12.1	18	21.2	17
35-49,999	6.3	14	20.2	14
50-74,999	2.1	12	11.8	12
75,000	0.7	10	5.3	9
Total	100.0		100.0	

Median Income $13,400 $24,400

Source: U.S. Bureau of Census and
HUD 1983 Annual Housing Survey

TABLE II
Cumulative Effects of President's Proposal
Mortgage Interest Rate = 14 percent

Holding Period	8 years		18 years	
Inflation Rate -	4%	6%	4%	6%
A. Rental Income as % of Total Development Cost required to produce ATIRR of 15%	21.4	17.4	20.6	17.1
B. % Change in rent required to produce ATIRR of 15%	+12.6	+18.4	+17.7	+22.1
C. % Change in value from base before any rent increase above assumed rate of inflation	-11.7	-15.6	-15.0	-18.3
D. ATIRR before any rent increase above assumed rate of inflation	+12.1	+11.8	+11.8	-12.4

APPENDIX II
THE ANALYTIC FRAMEWORK

To analyze the effects of changes in tax legislation, Brueggeman used a variation of the present value framework he previously had employed in 1977 and 1982, and that of de Leeuw and Ozannee in 1979. In the framework, cash flows related to development costs (adjusted for cash flows related to development phase), after-tax cash flows from annual operating revenues less expenses, and after-tax cash flows from the sales of the property in some future year are discounted by a required after-tax rate of return until equality between inflows and outflows is achieved. More specifically, the after-tax rate of return (K) on equity invested in a real estate income property investment can be determined from:

$$\sum_{i=1}^{d} \frac{(TDC_i - DF_i)}{(1+K)^i} = \sum_{i=1}^{s} \frac{(R_i - O_i - I_i - P_i) - (R_i - O_i - I_i - D_i - A_i)\, t_o}{(1+K)^i}$$

$$+ \frac{V_s - B_s - S_s - G_s t_g - RC_s\, t_o}{(1+K)^s}$$

TDC = total development costs, including land (L)

DF = development financing

d = end of development period

s = holding period in years

R_i = rental income in year i

O_i = operating expenses including property taxes, in year i

I_i = interest on mortgages paid in year i (adjusted for inflation under Treasury proposal)

D_i = tax depreciation taken in year i

A_i = amortization of construction period interest and property taxes (becomes 0 in Treasury proposal and is included in depreciable basis)

t_o = marginal ordinary income tax rate

t_s = marginal capital gains tax rate

P_i = principal portion (amortization) of the loan payment in year i

V_s = estimated value and selling price in year s

S_s = selling and other transaction costs in year s

G_s = capital gain, net of selling costs (S_s) resulting from sale in year s

RC_s = net excess depreciation (accelerated over straightline) which is recaptured upon sale (if relevant)

B_s = balance of mortgage in year s

K = nominal after-tax discount rate on equity investment in a property held for s years

In the long run, we would expect that the present value of after-tax cash flows, when set equal to the present value of equity invested in the property would result in the marginal investor earning a competitive, after-tax rate of return (K) if the property is held for s years. The holding period (s) and the value of the property when sold (V_s) would be such that a buyer in year 's' would also earn the same after-tax rate of return on equity from the same remaining economic life of the property. Similarly, if the after-tax rate of return is given, the Equation can be rearranged and rents (R) can be determined given estimates of other variables.

In the analysis, the total development costs (TDC) are equivalent to the demand price for a project. Then, given a value of 'K' and inputs for land, development, and operating expenses, capital gains treatment (relevent under current tax legislation) and transactional cost, the initial level of rents (R) necessary for investors to earn a required after-tax rate of return on equity can be ascertained. After this equilibrium relationship between R and TDC is established, the market effects of changes in relevant tax variables can be examined for rental properties. By making appropriate changes in the equation for tax variables in question, a new equilibrium relationship between R and TDC is established given that the same after-tax rate of return must be earned by the investor. The short run impacts on value and after-tax internal rates of return can be estimated from the simulation, assuming rents do not rise to offset the tax law changes. The longer term impacts would be determined by market adjustment forces.

To analyze the impact of tax changes on the residential rental property, a Base Case example of a recently developed rental property under current tax laws was established. The Base Case assumptions shown in Table II in the body of the text were produced from a representative sample of properties.

The simulations of the impact of the effects of the proposed changes were run under different assumptions regarding inflation, interest rates, and holding periods.

BROWNSTEIN ZEIDMAN AND SCHOMER

STATEMENT
OF THE
NATIONAL ADVISORY COUNCIL OF
HUD MANAGEMENT AGENTS
ON THE IMPACT OF THE PRESIDENT'S TAX PROPOSALS
ON THE EXISTING MULTIFAMILY STOCK

July 16, 1985
SENATE FINANCE COMMITTEE,
U.S. SENATE

The Advisory Council

The Advisory Council of HUD Management Agents is a representative group of 36 independent management firms from all parts of the country. They are responsible for the management of approximately 35 percent of all Department of Housing and Urban Development ("HUD"), Farmers Home Administration and State Housing Finance Agency - financed rental housing in the country. Our officers, for instance, are aware of housing issues in many sectors of the country: Council President Daniel B. Grady is from California; First Vice-President William Kargman from Massachusetts; Second Vice-President Irwin Yeagle, New Jersey; Secretary Robert Shirer, Florida, and Treasurer Harold Platter, Tennessee. We engage in an ongoing dialogue with the regulatory agencies on procedures, practices and regulations that will make housing work better; we also try to practice what we preach. There are over two million units of such privately owned housing in existence today. As we discuss in our testimony, we are concerned about the serious impact of the President's reform proposal on all rental housing. We are, however particularly concerned and focus our testimony today on these existing two million units. Quite simply, the President's proposals will have a devastating impact on this housing and its residents.

Most of these units are in projects that are 8-18 years old today, and increasingly in need of capital repairs. By and large, with the help of governmental subsidies, they have paid their own way over the years, but have produced little or no cash flow, and lack adequate reserves or other funding sources to pay for immediate repairs or to replace major systems.

The Federal Government's Role And Investment

There is nothing surprising about this state of affairs. Congress consciously provided that the sole economic incentive to create much of this housing for its residents rested on the tax benefits available to existing and future owners. Congress made a conscious and correct judgment that private industry utilizing the Tax Code can provide better housing cheaper than can the government. Regardless of the merits of this particular subsidy and delivery system, it is a reality and billions of dollars of private and federal money have been invested that depend on these assumptions. Most of these projects have restricted rents, restricted returns and restricted uses. In short, they have no economic utility. To a large extent only the traditional tax advantages for real estate and the ACRS system enacted in the 1981 tax bill have kept thousands of these units, particularly those financed under the Section 221(d)(3), Section 236 and Rent

Supplement programs, intact. They are the incentives for present and future owners to invest millions of dollars in refurbishing and maintaining these projects.

Even with these incentives, many of these units fall into default on debt service, with subsequent assignment of mortgages to HUD (or to the Farmers Home Administration or State Housing Finance Agencies) with a consequent and immediate payment of insurance claims. Without suggesting that the available figures are completely definitive, some data is available to suggest the gap between the costs of maintaining or rehabilitating existing units (a cost ranging up to $1,000 per unit) and the costs of assignment to HUD. HUD estimated actual assignment per unit costs at $16,355 in FY 1982, and $24,300 in FY 1983. Even accepting HUD's explanation that the latter figure may be skewed by assignment of a single large project, the assignment cost is major -- and the basic dollar figure cannot reflect the losses in terms of rehabilitation deferred, neighborhood deterioration, and the subtle wearing down of the quality of life for tenants. If, as HUD has estimated, perhaps 2500 units were to be assigned to HUD in 1984, and assuming a $20,000 median per unit cost, then the so-called revenue neutrality of the tax proposals begins to be eroded. (*See* attached letter from HUD Secretary Pierce to Senator Riegle, May 22, 1984, p. 5.) What is true in this single cost area can be replicated in a series of analyses that suggest, as a bottom line, *that the losses attendant on enactment of the tax proposals affecting this real estate alone may overwhelm the savings to Treasury.*

The Housing Stock

The Council's primary objective is the preservation of the existing govermental financed multifamily stock. The projects we manage represent an enormous federal investment that will probably never be replicated -- the programs are not there, the commitment is not there, and the cost in today's terms would be staggering. The existing inventory represents an irreplaceable resource.

But it is a troubled resource. An industry study in 1983 revealed that almost 10 percent of the existing inventory had an average immediate need of $800 per unit for replacement and repairs. The more recent experience of investors and developers of older projects suggests a per unit expenditure of $1,000 is more realistic.

Why bother? Where is the money to come from? The imperative to preserve this stock will be echoed in numerous presentations before this committee, before Ways and Means, and before the Banking and Budget Committees.

The Need

The need for rental housing for low income Americans is of a magnitude only incompletely documented. Our free market economy has produced such housing driven by two forces -- direct federal subsidies and the incentives built into the Tax Code. The federal subsidies are, to all intent, gone. Even if you disagree with our belief that the Tax Code should be used for social objectives, the bottom line is that the existing tax incentives represent the only option available to maintain the physical integrity of our existing rental stock. The prospect of sale for the last several years has represented the only significant source of capital for preserving these projects. Through a detailed and thorough review process, "the TPA Process", HUD, and state agencies, review each proposed sale of a project and approve it only when satisfied that a project's physical and financial needs are being addressed. Without the tax incentives Treasury II eliminates there is no way real estate in general, but these projects in particular, can compete for critical investment capital.

The high cost of denying investment capital to existing housing -- an almost inevitable result if the real estate provisions were enacted as proposed -- is exacerbated by the lack of other alternatives for the renter population, and particularly for the low income renter. Various analyses of the tax proposals postulate the following effects on renters:

1. Nearly 160,000 fewer multifamily housing units will become available each year following enactment.

2. The loss of tax incentives, including tax-exempt financing, will require sharp increases in rents; estimates range from a low of 20 percent to as much as 40 percent.

3. This has a double impact; renters per se have lower incomes and spend a greater proportion of income on rent than do other households, and will be less able to handle such

increases. Second, even a modest rent increase will offset any advantage low income households may have received as a benefit of proposed tax rate reductions.

4. The combined impact of these financial reversals tilts the thrust of the President's proposals heavily away from fairness. There is almost no disagreement that the proposals are weighted heavily in favor of homeowners, whose average income is significantly higher than the renter population. In 1983, for examples, median renter income was $12,900, compared to $31,000 for homeowners; but 8.4 million of these renting Americans had incomes below $7,000 per year.

These are poorer Americans, living in poorer quality housing, and most frequently representing populations with special needs -- the elderly, the handicapped, the single-parent families with minor children. Among these poorer rental households, over 60 percent, according to the Annual Housing Survey, paid more than 60 percent of their income for rent.

Tax Incentives for Investment in Existing Housing

The Council and other advocates for existing housing and the tenant constituency would not suggest that the Tax Code in its current form represents an adequate answer for the needs of lower income Americans. It is, for better or worse, the only remaining tool.

In terms of existing housing, this primarily means those Tax Code incentives that facilitate sale or resale. The sale or resale of existing housing represents the only option for attracting new capital to this stock. HUD staff has estimated that minus such sales, HUD would incur assignment costs for an additional number of units equal to 20 percent of the subsidized units currently being sold. (Pierce letter to Riegle, p.5) Although the Secretary suggests the available data is inadequate, he goes on to suggest "[I]t is clear that some transactions will be hindered . . . [those] most likely to be able to advance housing objectives are those most likely to be halted. The reason is obvious: any incremental reduction of tax benefits will reduce the amount of cash that can be raised to meet project needs in addition to the private demands of sellers." The Secretary continued, "Management of that investment [i.e., the insured inventory] has been and will continue to be one of the most challenging tasks of the Department." The Advisory Council of HUD Management Agents concurs; and urges the Congress not to eliminate those tax incentives that are the last protection of the existing housing stock and tenants who depend on it to meet their complex housing needs.

The private sector, we believe, can respond. Despite the all too common perception of real estate and real estate investors, I hope what you hear over the course of this debate is not primarily special interests but special responses to unmet needs -- the needs of our neighbors, our neighborhoods, our communities and those who live in them -- the average renter, the elderly citizen, the least fortunate among us.

The Council aligns itself with other advocates of low-income housing and the residents that are its true constituency in strong opposition to the elements of the President's Tax Reform Plan that would, if enacted, wreak havoc on our existing rental stock. In other hearings, witnesses were frequently asked, in one way or another, what is it in the Plan you absolutely cannot live with? The Council, although recognizing that at least eight provisions will have serious negative effects on real estate, would have to focus on three major provisions.

The Critical Elements of the Tax Reform Proposal for Housing

1. Provision: The Extension of the At-Risk Rules to Real Estate

Simply put, no investor would be willing to be personally at risk on a low-income, limited dividend rent controlled property subject to regulations that affect management, tenant relations, rate of return, and long term use. The limitation of at-risk rules is not simply an accident of the Tax Code. It has been an essential element in the development and maintenance of this housing.

RECOMMENDATIONS:

-- The extension of the at-risk rules to real estate should be refined to target abusive transactions.

-- An exception to the at-risk rules should be available for unrelated third-party institutional financing if the at-risk rules are extended to real estate.

-- An exception to the at-risk rules also should be available for all seller financing of existing governmental financed housing so long as such transactions meet existing regulatory requirements. Because of these regulatory requirements (which generally prohibit second mortgage liens), seller financing is the only way of withdrawing equity.

2. Provision: The Deductability of Investment Interest

The President's proposal would extend the definition of investment interest to all interest expenses incurred by a limited partnership. Under current law, interest expense of a limited partnership is generally fully deductible by the limited partners. The President's proposal would also reduce the amount of investment interest that could be deducted from $10,000 to $5,000.

This, like other proposals, is aimed at perceived "fat cat" abuses. There certainly is money to be made in real estate. But it is interesting to learn, according to testimony of the American Real Estate Committee, that the average investment of a limited partner in publicly registered transactions is between $2,000-$10,000. The aggregate of such investment, and its attendant tax benefits under current law, is critical for our existing housing stock.

The deductibility of interest expense against other investments is a principal incentive for investment. Low and moderate income housing, because of restrictions on rentals and on rates of return, does not generate large amounts of net income, if any. Low-moderate income multifamily housing thus would be particularly disadvantaged because the lack of excess income in its projects would reduce the value of the existing available deduction.

RECOMMENDATIONS:

-- Should the provision be enacted, investment in low and moderate income properties should be excepted.

3. Provision: The President Proposes to Stretch Out the Depreciation Period for All Real Estate

Depreciation is not just an accounting trick or device. Real estate wears out. It is as simple as that - renter turnover, families, a certain degree of overcrowding, the diminished sense of responsibility for non-owned property, the need to serve a lower-income population that frequently has less income and energy to care for property, and the location of many existing properties in declining neighborhoods combine to create tremendous stress on the physical plant. After five years the building system begins to need repairs. Within ten years major systems, including HVAC, begin to sputter and collapse. This natural process, we have learned, is exacerbated in projects serving lower income families.

Investment for maintenance is not unusual; nor restricted to low-income or rental property. The special problem in the federally insured projects is the absence of cash flow, resulting in inadequate or no reserves or other funds to pay for repairs or replacements. No funds; no repairs; no incentives to attract new funds. The eventual result will be a private walkaway that will outstrip the federal walkaway from housing. Deterioration and abandonment will erode whatever small improvements we have made in our urban landscapes. The losers, once more, will be the most vulnerable.

The specific ability of low-income housing to compete for capital with a) other housing and b) other investments rests on the special depreciation incentive available to it. That special need was underlined less than a year ago when the Congress excepted low-income housing from the 18-year depreciation enacted for all real estate in the last tax bill. The turnaround represented by this proposal flies in the face of logic.

RECOMMENDATIONS:

-- Retain the 15-year depreciation period for low-income housing.

-- If the provision is enacted in some form, other real estate should be depreciated over a period less than the 28-year period now under consideration.

-- In the best of all possible worlds, the Congress should scrap the depreciation proposal and stay with current law -- the changes made last year just have begun to work through the market.

* * *

There are at least five other elements of the tax reform plan that are injurious to real estate and housing: the repeal of Section 167(k) and Section 189, the repeal of all existing rehabilitation credits, the repeal of capital gains treatment for depreciable property, and the elimination of tax-exempt status for housing bonds. While other groups will address those issues more specifically, and with supporting data, the Advisory Council of HUD Management Agents supports their opposition to the real estate proposals for at least three reasons:

1. Treasury II ignores the economic stimulus real estate development provides in terms of jobs and revenues as well as value added to our neighborhoods, cities and states. Several groups have testified that in what is touted as a "revenue neutral" proposal, the lost revenues associated with a specific incentive or incentives equal or exceed the savings to the Treasury.

2. The crushing impact of the proposal on housing is hard to view as equitable when you represent a sector that already has taken a disproportionate share of the hits: over 60 percent of the cuts in domestic federal assistance programs were made in housing-related programs. Another study indicates federally assisted housing programs have borne a reduction of 55 percent in new assisted units, 68 per cent in new budget authority, and 83 percent in unit reservations for new/substantially rehabilitated housing -- "possibly the deepest cuts incurred by any of the domestic programs."

3. In the aggregate, the housing proposals hurt most those the plan is advertised to help: the poor and the less able. These are disproportionately represented among renters. The plan is tilted heavily in favor of preserving homeownership benefits; at the same time any savings effected by a potential reduction in tax rates will be cancelled and overridden by higher rents caused by the President's plan.

Some Exploratory Alternatives

Fairness demands that every industry and every sector of our society accept some share of the burden of our current economic situation; indeed, the early years of this decade made it clear that the housing industry suffers longer and harder in recessionary times. The Council, and other industry groups, would hope to work with the Congress over the next months to see how the proposals may be tempered if a tax reform plan must be enacted.

The Council continues to believe that maintenance of the existing housing stock should have first priority. It understands, however, that the housing sector may have to do more to receive the benefit of federal incentives via the tax code.

A concept worth exploring is that of recapture; i.e., the return of some portion of investment income (tied to tax incentives) to a participating entity. The Council has no position at this time as to whether recipients could be tenants (through rent reductions), a tenant organization, a community organization or a local housing agency or local government, but would be willing to participate in any dialogue or working group that might develop around such issues.

Other groups and individuals may have other cost effective recommendations as to where savings are possible or how the provisions can focus on actual abusive practices rather than punitively on a whole industry and its constituency. The Council urges the Congress to consider all the options brought to it before dismantling existing law -- and taking housing down with it.

THE SECRETARY OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

May 22, 1984

Honorable Donald W. Riegle, Jr.
Subcommittee on Housing and Urban
  Affairs
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Riegle:

Thank you for your letter of April 4, 1984, regarding the potential impact of the so-called "OID provision" of the pending tax legislation which, at that time, had been reported by the Finance Committee and was awaiting floor action. You asked for our comment on how this proposed change could (1) reduce private investment to maintain the habitability of existing, HUD-assisted low income rental housing, and (2) affect future FHA Insurance Fund obligations. In addition, you asked whether a "Net revenue effect" table prepared by the Coalition for Low and Moderate Income Housing reflected the Department's estimate of the fiscal effects of exempting HUD-assisted housing from the proposed tax amendment.

Subsequently, the Senate agreed to the "Deficit Reduction Tax Act of 1984" offered by Senator Dole after tabling the amendment offered by you, Mr. Cranston, and others which would have exempted certain HUD-assisted and other low-income rental housing from the "OID provision," which comprises Section 74 of the Act. Because the deficit reduction package passed by the House contains a similar provision, I am assuming that the "OID provision" will be enacted. We have, therefore, begun to assess the potential impact of this change within the context of a larger effort to analyze the condition and needs of the inventory of subsidized low-income rental projects with HUD-insured or HUD-held mortgages, plus projects owned by HUD.

There is a substantial inventory of low-income rental projects with FHA-insured or Secretary-held mortgages with pre-Section 8, relatively shallow subsidies. The major portion of this inventory consists of approximately 440,000 units insured under Section 236 and approximately 154,000 units insured under Section 221(d)(3) with below-market interest rates (BMIR). Few of these projects are able to generate cash from operations that is sufficient to maintain full reserves, much less fund capital improvements. Many fall into default on debt service, resulting in assignment of mortgages to HUD (and consequent immediate payment of insurance claims). The tax benefits available from resyndication -- or, in our terminology, transfers of physical assets (TPA's) -- have provided a means of obtaining cash contributions from new owners necessary to cure delinquencies, fund reserves and deferred maintenance, and even fund repairs and replacements chargeable to capital account (boiler, roofs, etc.).

Encouragement of TPA's as a vehicle for obtaining capital infusion for low-income rental projects began several years before enactment of the Economic Recovery Tax Act of 1981. At that time, however, the activity was limited to transfers by nonprofit owners to tax-motivated limited dividend owners. The increased tax benefits for acquisition of existing properties which were made available by ERTA, plus the availability of interest deductions arising from seller secondary financing on which actual payments were deferred, made it possible to raise an additional amount of cash in a TPA transaction sufficient to cover a taxpaying seller's tax liability arising from the transfer, which made it feasible to extend the process to transfers by existing limited dividend owners to new limited dividend owners.

It is clear to me that the interests of the Department have benefited from many of the resyndications of subsidized limited dividend projects which have occurred since enactment of the Economic Recovery Tax Act of 1981. Re-commencement of the tax incentives created for low-income rental housing at a point in time when those benefits have largely spent themselves provides an occasion for an infusion of necessary capital into a project. It is also clear that the tax losses attributable to accrued interest on secondary seller financing have been a major factor in permitting extension of the resyndication process to existing limited dividend projects. Information normally available to us does not permit an analysis of the tax impacts of TPA's on either sellers or buyers, so we do not have an independent data base on this point. However, we have examined a representative sampling of offering statements and other data relating to actual transactions, and the information disclosed is confirmatory of the impression gained by our staff from participation in negotiations. We are satisfied that interest deductions attributable to secondary financing account for losses that are in the order of 20 percent to 35 percent of the tax losses realized during the first five years after resyndication. Put another way, the absence of these deductions would reduce the ratio of loss to investment during that period, in what would appear to be representative cases, from approximately 2:1 (the amount necessary to provide recovery of investment by a 50 percent bracket taxpayer during that period) to approximately 1.6:1. Under current market conditions at least, we understand that the latter ratio would not be considered marketable in the case of a low-income project. Accordingly, as transactions have been structured during the past several years, the accrued interest deductions have been critical to feasibility of the transaction in a substantial number of cases.

I hasten to add that I do not believe that the current deductibility of deferred interest, with the concurrent nonrecognition of income by a cash-basis seller-payee, is an efficient or desirable means of subsidizing these transactions. It is difficult to avoid agreement with the Treasury's view that this constitutes an accounting abuse. Further, it is particularly inefficient from a housing policy perspective, in that it makes no distinction between buyer contributions which aid the project and contributions which aid only the seller or syndicators. As I've indicated, the principal factor leading to the extension of the resyndication process from solely nonprofit owners to limited dividend owners was the new ability to raise enough cash to cover the sellers' tax liabilities. Studies made available to us indicate that well over half of the cash raised in transactions typically is devoted to this purpose, and the portion of the cash raised which is devoted to property needs is only about 20 percent or less. On the basis of this data, it is difficult to assess the net benefits derived from extension of the process to this class of sellers. Of course, many subsidized projects which are resyndicated because of the benefits of current law need not be considered candidates for assignment in the absence of resyndication. In these cases, I cannot say that the benefits of resyndication outweigh either the tax revenue losses that result or the defects in the rules that create the losses.

I also cannot estimate with any certainty how many transactions which might have occurred under current law will not occur because of enactment of the OID provision. Any such estimate would have to take into account the availability of other devices to achieve comparable tax results, the impacts of other tax changes on competing investments, and the willingness of sellers to accept a pricing change necessitated by law changes. Largely for this reason, I am unable to affirm the estimates of tax revenues and losses provided by the Coalition.

An estimate of how many transactions occurring under current law will not occur because of the change of law is critical to both the "Income tax paid by sellers" line and the "Income tax (Deferred by new buyers)" lines of the table. (For convenience, I am referring to the version of the table which was reproduced in the Congressional Record at page S 4258 (April 10, 1984).)As I understand the intent of this portion of the table, the "Income tax paid" line should indicate sellers' tax payments for only those resyndication transactions which will not occur without an exemption. The table appears to be based on an assumption that all subsidized project resyndications occurring under current law will be halted by the change in law (see footnote 3). As indicated above, I am not prepared to confirm this assumption, so it appears likely that the estimated revenues included in the "Income tax paid" line are overstated.

At the same time, the tax deferrals indicated in the lines following are also likely to have been overstated. The deferrals shown in the table include all reductions in tax revenues arising from both deferred interest payments and 15-year ACRS depreciation. I believe, however, that the only pertinent deferrals would be (i) all revenue reduction arising from transactions which would not occur without the exemption, plus (ii) additional revenue reduction attributable to deferred interest payments from transactions which would occur without the exemption. In other words, the pertinent revenue reduction should not include tax deferrals attributable to depreciation for the transactions which will occur without the exemption.

Accordingly, our best guess is that both the "Income tax paid" and the "Income tax (deferred)" lines of the table are overstated. As a result, I am unable to provide an estimated subtotal for annual "Tax revenue gain (loss)." Of course, it is evident that the revenue reduction arising from transactions occurring in the years shown in the table will continue for a number of years past those shown.

I would like to be in a better position to give detailed and definitive analysis of the "Savings generated for HUD assignment program" line of the table. Regrettably, we are not fully able to do so. As noted above, transfers of limited dividend owner projects only began to be an extensive activity in FY 1982, after enactment of ERTA. We only began to keep record of the number of such transactions which were occurring in mid-FY 1983. We have not yet aggregated and analyzed this limited experience to inform ourselves of its results in terms of capital infusions achieved for projects, amounts of debt service and reserve fund arrearages collected, deferred maintenance and repairs funded, and so forth. Also, information necessary for estimating tax impacts of transactions on sellers and buyers normally is not available to us. The unavailability of this data is critical to our inability to estimate with any precision the expected impact of the change of tax law in terms of number of transactions which will not occur or differences in terms of transactions which will continue to occur.

Subject to the foregoing limitations, I offer the following comments on various elements included in the "Savings generated" data presented by the Coalition. It is true that these estimates were developed by the Coalition following consultation with HUD staff.

The number of units covered by syndicated TPA's in FY 1983 for all insured projects and for subsidized projects only (shown in the first lines of the table) represent annualization of half-year figures. As indicated above, we began to keep track of this activity in mid-1983. The FY 1984 amounts, similarly, are annualizations of activity through the first six months. We have no basis for confirming or questioning the validity of the estimates of activity level projected for future years.

HUD received 69 multifamily assignment claims in FY 1982 and

60 claims in FY 1983. (These represented declines from 84 in FY 1979, 79 in FY 1980, and 92 in FY 1981. The decline is attributable in part to the decline in prevailing interest rates, reducing a lender's incentive to assign, and, to a degree not calculable, to anticipation of potential resyndication following enactment of ERTA.)

When discussing this data with the Coalition, we estimated that the average number of dwelling units covered by each assignment claim was 100. The actual number of units covered by assigned mortgages were 7,082 in FY 1982, 5,749 in FY 1983.

The "Federal Cost Under Present Law" amounts for FY 1982 and FY 1983 shown in note 5 represent unpaid principal balances of mortgages received for assignment in those years. There are, of course, other assignment costs, particularly post-acquisition holding costs, which are offset by an eventual 30 percent (average) recovery on disposition of the property after foreclosure and acquisition of title. Without further detailed calculation, we consider that utilizing unpaid mortgage amounts provides useful rough estimates of actual assignment costs. Based on the unit figures stated above, the per-unit costs in FY 1982 were $16,355 and in FY 1983 were $24,300. (The FY 1983 per-unit amount was impacted heavily by a single large project which included much commercial space, distorting the amount when divided by residential units only.)

The estimate that 2,500 units will be assigned to HUD in FY 1984 represents an annualization of the experience of the first six months. The projected annual cost for this year (based on unpaid mortgage amount, as discussed above) is $16,062. The decline in assignments in FY 1984 from FY 1983 is attributable to a number of factors, including further decline in interest rates early in the fiscal year, a tougher HUD posture in moving projects quickly from assignment to foreclosure (with a resulting less casual attitude on the part of borrowers toward defaults that trigger assignments), and availability of Section 8 loan management set-aside funds in FY 1983.

In discussions with Coalition representatives, HUD staff provided an estimate that, in the absence of resyndications, HUD would incur assignment costs for an additional number of units approximately equal to 20 percent of the subsidized units currently being resyndicated. Given the absence of analyzed data regarding our limited experience to which I referred above, this estimate was extremely rough. (For instance, it did not take into account the number of units covered by syndicated TPA's in FY 1983 in projects whose mortgages had already been assigned to HUD.) Nevertheless, we still have no better one to offer, and I do not wish to imply that this assumption, which is key to the projections offered by the Coalition, is necessarily invalid. I must caution, however, that the estimate was made against a background of current activity levels, so that it does not necessarily follow that the amount of units assigned would necessarily follow that the amount of units assigned would increase progressively in future years. In fact, the rate of assignments in the absence of resyndication is likely to be influenced more directly by the levels of available loan management set-aside and flexible subsidy assistance than by the level of resyndication activity. In addition, the estimate was not intended to imply that the assignments would be likely to occur in the same year that, under current law, a resyndication might have occurred. In fact, an assignment would more likely occur several years later in most cases. Also, as the figures shown above indicate, there is little historic basis for an assumption that per-unit costs also will increase.

For the reasons stated above, therefore, we are not able to quantify with an acceptable degree of comfort the likely impact of the tax law change on the HUD-insured inventory. Nevertheless, it is clear that some transactions will be hindered and, more pertinently, that it is the transactions most likely to be able to advance housing objectives that are the most likely to be halted. The reason is obvious: any incremental reduction of available tax benefits will reduce the amount of cash that can be raised to meet project needs in addition to the private demands of sellers. Therefore, the transactions which would contribute the most toward project needs are precisely the transactions most likely to be halted by the tax change.

We recognize this result and are determined to face up to it. The inventory of existing assisted multifamily housing represents an important Government investment. Management of that investment has been and will continue to be one of the most challenging tasks of the Department. As suggested above, I do not believe that any adverse impacts of the tax law change will be immediate. There should, therefore, be sufficient time to consider more rational and efficient alternatives before the matter reaches crisis proportions. Assistant Secretary Barksdale has commenced a concentrated program to develop a comprehensive profile of the current condition and projected needs of the inventory as well as an evaluation of the effectiveness and efficiency of different tools for its preservation, including flexible subsidy, loan management rental subsidies, tax incentives, and possible additional means. I want to assure you that I regard our responsibility and our accountability to the Congress in this respect as a serious and pressing matter, to which we must respond intelligently and forthrightly.

Very sincerely yours,

Samuel R Pierce Jr

Samuel R. Pierce, Jr.

STATEMENT OF
THE NATIONAL ASSOCIATION OF
INDUSTRIAL AND OFFICE PARKS
PRESENTED BY
JAMES M. MILLER
TO THE COMMITTEE ON WAYS AND MEANS
OF THE
U. S. HOUSE OF REPRESENTATIVES
JULY 9, 1985

Mr. Chairman. Members of the Committee. I am James M. Miller, a partner of The Miller-Valentine Group of Dayton, Ohio, and a past president of The National Association of Industrial and Office Parks (NAIOP). The Miller-Valentine Group has been involved for over 15 years in the development and management of 31 light manufacturing, distribution and high technology buildings representing 3,110,00 square feet and seven office buildings with 405,000 square feet. Currently we have another 129,000 square feet of office buildings under construction. More than 150 companies lease space from us ranging in size from small, startup high technology companies to General Motors Corporation and American Telephone and Telegraph Company.

I am here on behalf of the National Association of Industrial and Office Parks. NAIOP is a membership organization of 4,400 professionals involved in master-planning, designing, financing,

naiop National Association of Industrial
and Office Parks
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constructing and managing industrial and office park properties. Of our 4,400 members, nearly 2,500 are professional developers who have an ownership interest in a business park or building. The remaining NAIOP members are executives who support the development industry in areas such as banking, brokerage and construction services.

Miller-Valentine and our colleagues in NAIOP are representative of the thousands of larger and smaller developers of commercial and industrial buildings and industrial and office parks throughout the country. We offer a much needed product to new and expanding companies -- efficient workplaces at competitive rates without requiring those companies to tie up costly or unavailable capital in long term commitments to fund the construction of their own buildings.

An example of this type of tenant can be found in Therapeutic Technololgies, Inc., a new company in the Dayton suburb of Beavercreek which has leased space to design and manufacture equipment that electrically stimulates muscle groups and neural systems to restore lost physiological functions which increase the chances for patients to return to a more normal lifestyle. Our ability to obtain financing for the construction of this specialized facility made it possible for TTI to relocate to the Dayton area near Wright State University's National Center of Rehabilitation Engineering.

For almost two decades our company has helped to encourage growth in Dayton by providing affordable space at reasonable terms to new companies starting up in our region and to help meet the expansion needs of companies already located within our region. Before we began operation, companies virtually were required to have a Triple A rating and to sign a 20 year lease before they could provide new and expanded facilities for their operations.

I am here representing not only my company but the 4,400 members of NAIOP. Our organization shares with you a desire to see our Federal tax system work fairly, efficiently and equitably for business and individual taxpayers. We want to commend your leadership and that of the President's in this effort and to recognize the important groundwork which has been laid by Representatives Gephardt and Kemp and Senators Bradley and Kasten and the other Congressional advocates of tax reform.

Your task will be difficult -- particularly since your goal is to achieve a revenue neutral result and to lower the marginal tax rates. Unfortunately, I believe the President's proposal before you places an unfair and disproportionate burden on our industry to make up lost revenues, and my statement addresses those areas which cause the greatest concern. At the same time we do not expect any reform effort to be cost free or without significant effect on our industry; moreover, I do not want this statement to mark the end of our participation in this legislative process. Our company and NAIOP are prepared to work with your Committee in the months ahead to discuss a reasonable basis for reaching some agreements in these areas of concern.

I would begin with some general observations about the President's proposal and its anticipated effect on our business. First we believe that the President's proposals will significantly increase the cost to companies like TTI of leasing offices and manufacturing facilities. We have prepared projections for a typical multi-tenant facility, factoring in the new tax rates, depreciation schedules, the investment tax credit, capital gains treatment upon sale, and the indexing of the asset basis for inflation. We believe these changes alone would require us to increase rents by at least 15 percent for facilities placed in service after this year. If your final proposal should not provide for indexing the property basis, rents would have to be increased by 25 percent to provide the same rate of return.

This projection is based on the following factual assumptions: A 5 percent annual rate of inflation; a sale of the property at the end of 10 years; a combined federal and state tax rate under existing law of 54.75 percent for ordinary income and 21.9 percent for capital gains, and corresponding rates under the President's proposal of 44.5 percent and 22.25 percent.

There is no method we can use to quantify in our projections the expected decline in building value, the effect on development companies and their investors of the proposed recapture of excess depreciation, the alternative minimum tax changes, limitations on the deductibility of investment interest, the revised treatment of construction period interest and taxes, or the absence of prospective effective dates and transition rules. We are confident that the cost of capital will increase significantly because of these changes and those costs will have to be passed on to the tenants in future projects.

Ours is a business which involves considerable risk for the developers and for our investors. Historically, it has been a business open to entrepreneurs willing to take those risks in return for the potential rewards for those with the accumen to anticipate market needs and business cycles. The rewards generally are realized in the long-term appreciation in the value of the projects and the skill with which they are built and managed. In order to do this, a developer of an office park, for example, often must make commitments far in advance of construction for the purchase of land. Then approval must be obtained from various state and local environmental, zoning and other governmental agencies. Finally water, sewer and electrical systems must be installed, streets constructed and the area landscaped before the first building is begun. This requires long term commitments of both equity and debt capital in anticipation of even longer term returns.

It has been our experience that it takes between 10 to 15 years to complete the development of an industrial or office park and to begin to recoup these development costs -- and that is if everything in the construction schedule goes as planned. Even in a small office building, if you set aside all of the tax considerations, it takes between five and six years before any cash return is realized on our investment.

The current tax system, while far from perfect, has evolved around a recognition of these delays between the investment and the return on that investment -- a risk which some more traditional sources of investor capital avoid because of the lack of liquidity or marketability of this type of investment. This places our product at a disadvantage to more marketable financial instruments, and we are concerned that the package before you would place us at a greater disadvantage.

The President's proposals would dramatically alter many of the traditional financial mechanisms used in our industry and would increase our risk and reduce our returns -- perhaps more than for any other single industry. I will discuss specifically the most important proposals, but first I would like to review some of the central issues for our industry which I believe are raised by the President's suggested reforms.

1. The elimination of capital gains treatment for depreciable property will drive potential real estate investors into alternative and more secure investments because it will reduce the after tax return on investments in structures. The taxation of gain on a building at ordinary rates also will tend to drive the new entrepreneurs out of our industry because they will be unable to accumulate sufficient capital to sustain their operations.

2. Real estate will be even less attractive to investors, again raising the cost of capital, because of the limitations proposed on the deduction by limited partners of their shares of partnership interest expenses.

3. Our industry, the Administration and the Congress must work to reach a better understanding about the appropriate useful lives for recovering our invested capital in an office building and other structures. Perhaps more informal discussion of actual experiences can shed new light on this important issue where various economic studies seem to have failed to be persuasive.

4. The proposed recapture of excess depreciation benefits expected to result from lower tax rates are confiscatory in that they

do not tax real economic income and their effect is particularly harsh for our industry.

5. While we applaud the statement issued earlier this year by Chairman Rostenkowski and Chairman Packwood to the effect that this legislation would not be applied retroactively, we are concered that there are no transition rules or prospective effective dates provided in the President's proposals and that merely including this basic provision for fairness will add significantly to the revenue loss of the package.

6. Finally, but perhaps most important, we believe the complexity of the President's proposals is an issue by itself. We recognize that the tax laws often will reflect the complexity of the business activities to which they apply. However, we are still attempting to understand how to apply provisions of the 1982 and 1984 tax bills. Yet those acts are eclipsed by the President's proposals. While it is difficult for us to fully assess their total impact on our industry, I would challenge your Committee and the Treasury Department to develop a realistic assessment of that impact for our industry to respond to before you adopt these proposals.

More specifically I want to address the major elements in the President's proposals which we believe would be most harmful to our industry. The changes of greatest concern to NAIOP members are those proposals affecting:

1. CAPITAL GAINS TREATMENT OF DEPRECIABLE ASSETS

The President's proposal to tax the gain on depreciable trade or business property held for more than six months we believe would create a distortion in the market favoring investments in stocks and other financial investments over investments in real property.

Perhaps the principal incentive for investment in real estate is the anticipation of appreciation in its value. This has contributed to a healthy pluralism in our economy where real estate investors may include the individual who rents one of his duplex apartments, the limited partner who owns part of an office building or hotel, or the pension fund which puts up all of the equity or debt capital for a building.

While the proposal to index the basis of real property would help offset the effects of inflation, it would apply an unfair tax rate at the point in time when all prior gain has been accumulated and it would tend to lock in investments in structures making them less attractive than investments in stocks and other equities. This provision would particularly discourage entrepreneurs in our business -- entrepreneurs who sell one building and then use the proceeds to acquire land and begin the next building. It also will tend to favor the more active development by pension funds and other tax exempt or low tax institutions which would further tend to drive the entrepreneur out of real estate development.

2. EXTENDED DEPRECIATION PERIODS FOR BUILDINGS

The President's proposals would extend the recovery period for structures to 28 years and would index the basis for inflation. This is a marked improvement over the November 27, 1984 Treasury proposal but is far from providing a counter-balance, as the Administration implies, for dramatically altering the capital gains treatment on the sale of a building. NAIOP did not plead for shorter recovery periods in 1981, but we did argue against the inequitable distinction between different classes of property and between the various types of owners of property. While our industry perhaps could accept longer recovery periods than provided under current law, we urge you to study carefully what is happening to the real economic life of buildings today and those to be built in the future.

The fact that a building physically may be standing 40 years after it was constructed bears no relationship to its value to the owner or to its prospective tenants. The perception that the real economic life of a building is 28 years, or 35 years or 40 years is pure fiction.

For example, last year my company invested an additional $2,002,615 to retrofit a building we had constructed for $2,143,000 in 1979 -- only five years earlier. Between 1980 and 1983 we spent an additional $248,000 on tenant improvements even before making the retrofitting expenses. Similarly, most developers in recent years have had to incur substantial expenditures on buildings constructed in the last decade because of the competitive demand for more energy efficient structures.

The increased specialization and technical requirements of tenants in the 1980's has moved our members toward construction of "smart buildings" equipped to monitor their energy and security requirements and to provide the latest internal communications capabilities. While these are positive steps to improve our future workplaces, they impose a greater burden and expense on each of us to make our existing structures more competitive with modern innovations in newer buildings. Too often I believe it is assumed that the "economic life" of a building is to be equated with the duration of its shell without considering the ongoing effort and expenditure required to keep a structure properly equipped and competitive in a changing market.

3. RECAPTURE OF EXCESS DEPRECIATION

The proposal to "recapture" excess depreciation which is expected to result from the application of lower tax rates to earnings from property placed in service under more favorable ACRS depreciation periods between 1981 and 1986 has a particularly harsh effect on our industry.

The most disturbing feature of this proposal relates to our previous statement about the useful lives of real property. The amount to be recaptured is based upon the differential between ACRS recovery periods and the 40-year recovery period for buildings under the earnings and profits provisions. However, 40 years is not an accurate measure and would result in the taxation of the equity invested in a building, not the income earned from its use. Another concern is the failure to deal with a sale of the depreciated property before the new rates become effective. In this instance, a taxpayer would enjoy no benefit from the lower tax rates but still would be subject to the recapture tax.

If that taxpayer holds onto the property, the rate of tax is so high that it far exceeds any minimum benefit to be obtained from lower rates and there would be no cash income to pay the tax.

4. APPLICATION OF THE AT RISK RULES TO REAL ESTATE

The President's proposals would apply the at risk rules to investments in real estate and could cause serious dislocation within our industry. The use of nonrecourse financing is an acceptable and established practice in our business. While my company fully guarantees construction period financing until a building obtains permanent financing and is placed in service, the permanent loan customarily is obtained on a nonrecourse basis because the lender knows there is a fixed asset supporting the note.

Like other limitations on investments through limited partnerships, this tax proposal would force a restructuring of investments in real estate which is likely to crowd out the traditional type of developer who seeks to support his borrowing with the value of the property. In the development of office and industrial buildings and parks, traditionally a building is constructed using a limited partnership, and my partners and I would serve as general partners. When a bank or other lender gives us permanent financing for the building, it looks to the value of the building to support the loan. Any personal guarantees by me or my partners would be illusory.

However, this limit could artificially limit our ability to develop any more buildings, because while the first lender on the building knows the loan is secured, other lenders for other projects would not have that background and might consider that a contingent liability and be less willing to grant a loan to us on the next project.

This certainly would be a disadvantage to independent developers and give a competitive advantage to institutional developers.

This is an area of the law that has been subject to overkill during the past five years. To the extent that there has been a problem with overvaluation of property, the Treasury Department has issued extensive regulations and the courts have rendered opinions limiting the ability to inflate the value of property for depreciation. Moreover, the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984 have all but eliminated the opportunities for overvaluation, particularly in the area of seller financing of real estate.

A more appropriate resolution of this problem would simply be to consider any partner to be at risk in a transaction if the full amount of the debt is secured by the value of the property and the debt is provided by a third party lender. In addition, any partner who is actively engaged in the development of the property should not be subject to the application of the at risk rules.

5. LIMITATION ON THE DEDUCTIBILITY OF INVESTMENT INTEREST

The President's proposal to limit the deduction of interest by individuals who are limited partners again falls very heavily on the real estate industry and one of its most important investment entities. Under current law, individuals who may be unable to afford direct ownership of real estate, nevertheless can benefit from investment in real property as limited partners. By aggregating consumer interest and interest from passive investments and subjecting it to an annual minimum, individual investors will be discouraged from investing in future real estate developments.

Ironically, the limitation is less likely to affect richer investors who have greater and more diversified income producing investments or who have the ability to arrange financing for real estate investments in ways to avoid the new rules. This limit would adversely affect many smaller developers who look to limited partner investors as major sources of equity capital.

Mr. Chairman, NAIOP offers these comments in a spirit of cooperation and support for the effort you are undertaking. We are reminded, however, of recent history concerning the adoption of tax legislation and the fact that our industry often appears to be an easy target for "reform." For example, when TRA was adopted, it was never suggested that recovery periods for all property be extended proportionally -- only that the period for structures be extended from 15 to 18 years. And this year, when many groups in our industry sought a correction in the amendments to the original issue discount rules which were adopted last year, the Congress extracted one more year from structures, even though it was acknowledged that the correction was needed, and even though far from a significant number of developers affected by the 19 year period have even used seller financing.

Mr. Chairman, we seek through your invitation to us today and through our subsequent discussions to establish a more effective and meaningful relationship with your Committee, and I appreciate having this opportunity to appear before you.

STATEMENT
BY
J. RODERICK HELLER, III
PRESIDENT
NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS
FOR ENTRY IN THE HEARING RECORD OF THE SENATE FINANCE COMMITTEE HEARINGS ON THE PRESIDENT'S PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY

July 16, 1985

The National Corporation for Housing Partnerships appreciates the opportunity to submit this Statement to the Committee. NCHP is unique, a private entity created in 1968 pursuant to Congressional authorization to accomplish a public purpose - the development of housing for low and moderate income families.

NCHP

- is the largest owner and operator of low and moderate income multi-family housing in the country, with almost 80,000 units,

- is the largest manager of low and moderate income housing - with 50,000 units under direct management,

- has never returned a single mortgage to HUD - an accomplishment requiring not only dedication and hard work but millions of dollars in project advances, and

- operates on a national scale, with 683 total projects in 42 states, the District of Columbia and Puerto Rico.

Indeed, members may be interested to know that NCHP has 208 NCHP properties in 15 of the 20 states which members of this Committee represent.

Significantly, none of NCHP's accomplishments could have been achieved without tax benefits of the type now threatened by the President's tax proposals ("Treasury II"). NCHP was created by Congress in 1968 precisely so that such tax benefits could be used to create low and moderate income housing. It is useful to recall that since the passage of Title IX of the 1968 Housing Act, Congress has repeatedly reviewed this issue and concluded that there is no way to construct housing for low and moderate income families without subsidies, both directly and through the tax code. Without question, enactment of Treasury II in its present form would eliminate the foundation upon which NCHP was created.

Nonetheless, this paper is not presented on behalf of NCHP's business interests. NCHP is now strong and flexible enough to adjust to adverse changes in the tax laws. But its constituency -- the low and moderate income families living in each of your districts -- is not. When I speak of NCHP's constituency, I speak not only of the inner-city poor, although that group ought to remain important in the national conscience. I speak of low-income families living in NCHP properties in small cities and rural areas all across the country. I speak of the elderly who are served by 94 of our senior citizen projects in 26 states. I speak of young people ages 20-30, whose net after tax income has fallen by nearly 14% in the last ten years.

Treasury II adversely impacts these broad and diverse groups for three basic reasons. The tax proposals:

- are fundamentally unfair to renters, especially those of low and moderate income.

- eliminate incentives to construct new rental housing for low and moderate income families.

- fail to provide incentives for the preservation of existing federally-subsidized rental housing.

I

First, our low and moderate income constituency consists of renters, and Treasury II treats apartment renters far less favorably than homeowners. This is so notwithstanding the fact that renters have fewer real dollars to spend on housing and are required to spend a higher percentage of their income on shelter than are homeowners. In 1981, the median income of U.S. renters was $11,400 compared to $21,800 for U.S. homeowners. Nevertheless, the recent study released by the National League of Cities reports that the housing-related tax expenditures for rental housing in fiscal 1985 is expected to be a mere $5.9 billion as opposed to the 49.3 billion being spent on home-owner deductions, including approximately 1.2 billion to owners of vacation homes. Another study released by the Wharton Econometric group concludes that an increase in rents of 20-24% by 1991 is certain to result from enactment of Treasury II. For a married couple earning $25,100, this represents a $700 - $1,100 rent increase. By contrast the same couple would receive a savings in taxes under Treasury II of only $100 a year. Such disparity in treatment between homeowners and renters is inconsistent with the principles of fairness on which tax reform was said to be premised.*

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* As further evidence of the disparity between ventures and homeowners, the National League of Cities reports that the average amount of federal housing expenditures per household was $124.80 per year for households with income over $10,000, rising to $1,866.48 per year for households with incomes above $50,000. The federal housing expenditure is a composite of both direct housing outlays and lost revenues through tax incentives.

II

Our second concern is that Treasury II virtually precludes the construction of new housing for low and moderate income families. Despite the efforts made over the last two decades, we are far from attaining the expressed national goal of "decent, safe, and sanitary housing" for every family. Under the most conservative estimates of a Brookings Institute analyst, the national need is a minimum of 2.3 million new rental housing units by the end of this century. Housing to meet this need will not be constructed without federal subsidies, both directly and through the tax code. Since present budgetary policies have drastically cut direct assistance for low and moderate income housing, tax provisions encouraging private investment in this type of housing are the only available means of satisfying this need. The Wharton Econometrics group has concluded that under Treasury II an actual reduction of 1,440,000 units of housing stock will occur by 1994.

Let me illustrate from NCHP's experience. The corporation's initial stock offering raised over $42 million in 1970 by offering major corporations tax losses to be realized in pursuit of the socially critical objective of building low and moderate income housing. NCHP has not sold more stock or otherwise received additional equity funds; the tax code has enabled NCHP to develop nearly 80,000 housing units by attracting investors to our limited partnerships. Since 1970, these investors have contributed almost $500 million to this development activity.

It is a fact that NCHP has been able to compete with other investment alternatives solely because the tax laws enabled it to provide competitive returns. Land prices, construction and financing costs, and operating expenses are so high today that rents even from moderate income families cannot provide sufficiently attractive rates of return for investors. In federally-assisted and state agency financed projects distributions are limited by law, if there is cash flow at all. NCHP's experience in over 500 projects suggests that cash returns in most projects will be minimal. Similarly, provisions restricting the use of such property to housing for low and moderate income families means that appreciation in value is a hope rather than a realistic expectation. Programs must be retained which provide investors in such ventures a competitive return while providing affordable rents to the low income tenant. To demonstrate how Treasury II affects the viability of such investments, consider that for the renter earning $13,000 a year paying 30% of his or her income in rent, $328 is the monthly rental cost. An apartment project built after Treasury II would have to charge rents of $539 a month to operate on a break-even basis and still give investors an 8% return. If Treasury II is enacted, either rents will go up in response to the new economics or new apartments won't be constructed - making the low income tenant the loser in either case.

Although almost every provision in Treasury II affecting real estate will adversely impact the tax benefits which are crucial to investment in low and moderate income housing, four provisions, in our judgment, are particularly egregious. They are (1) the extension of the at-risk rules to real estate, (2) the lengthening of depreciable (ACRS) lives to 28 years for all real estate, (3) the inclusion of limited partner interest expense in the interest limitation in Section 163(d) of the Internal Revenue Code, and (4) the elimination of private purpose tax-exempt bond financing. In this connection, we respectfully urge that an exception from the provisions regarding the at-risk rules and the determination of interest for purposes of Section 163(d) of the Code be made for HUD and state government-assisted housing and housing built with private-purpose tax exempt financing; and that provisions authorizing depreciation over 15 years for low and moderate income housing and tax-exempt bond financing for multifamily residential units be retained.

III

The third and principal area of concern for our low and moderate income constituency is not addressed in Treasury II: that is the preservation of the nation's existing stock of federally-assisted housing. Since 1968 Congress consciously has made a tremendous investment in shelter for the economically disadvantaged. It is essential that this Congress ensure that the investment represented by housing now under federal subsidy not be allowed to deteriorate.

There are approximately 440,000 units of Section 236 and approximately 154,000 units of Section 221(d)(3) below market interest rate projects in private hands. These projects are generally 10-15 years old and confronting major capital repairs. There are also hundreds of thousands of additional units receiving various forms of Section 8 assistance. Before the Tax Reform Act of 1984 became effective, HUD estimated in a recent General Accounting Office report that 3,000 - 4,000 properties were transferred to new ownership. Because of the loss of investment benefits associated with such properties, very few are likely to receive new ownership or capital in 1985.

There are no policies - and to our knowledge, few serious studies - aimed at ensuring that existing housing is preserved for low and moderate income renters. Of the nearly 600,000 federally-assisted units, most have enjoyed only marginal cash flow. Almost all will require repairs; an industry study in 1983 revealed that approximately 10% of the inventory had an immediate average need of $800 per unit for repairs and replacements. Our own experience in purchasing older projects suggests a required expenditure of up to $1,000 per unit. Beginning in 1982, we acquired 99 properties which were originally completed 10 to 15 years before. As part of this acquisition program, it was necessary to invest almost $8.5 million to preserve and upgrade units, thereby avoiding further deterioration.

Such investment for maintenance, of course, is not unusual; all improved real estate continually requires repairs and maintenance. The special problem in the case of federally assisted projects is the lack of cash flow, which means that there are inadequate funds to pay for necessary repairs and replacements. And the lack of an attractive cash flow means that owners have no incentive to invest additional funds for needed repair and replacement. The result is that too often they simply decide to walk away from these projects. We have previously testified before Representative Frank's Manpower and Housing Subcommittee of the Committee on Government Operations on the need for a Preservation Loan Fund to be administered by HUD Loan Management, but as yet no such fund has been established.

Today the only incentives for preserving existing housing reside in the tax code. At a minimum, we urge the retention of the existing Code provisions, at least insofar as they apply to the purchase of existing HUD-assisted housing. But Congress should go further. There should be incentives for the upgrading and preservation of existing properties in which the government has a stake.

We have analyzed various alternatives. One, for example, is to provide for shorter depreciable lives than now available for projects (a) which are acquired by new investors under HUD's approval process governing the transfer of such physical assets, and (b) in which a minimum of $1,000 per unit is invested in repairs and reserves for the acquired property. Another would combine the investment tax credit and shorter depreciable lives for investments exceeding $1,000 per unit incurred in repair and reserves of newly acquired federal and state assisted properties. We have not yet found a completely satisfactory proposal but in the future would like to submit alternatives for the Committee's consideration.

We recognize that in this time of needed austerity, recommending the inclusion of a new class of expenditures is at best unattractive; but we see no alternative. The failure to preserve this nation's present housing stock is very costly, and becomes more so with every year of inaction.

NATIONAL HOUSING CONFERENCE, INC.

FLOYD H. HYDE
President

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Board Chairman

KENNETH G. LORE
Board Vice Chairman

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Executive Vice President

STATEMENT SUBMITTED BY THE NATIONAL HOUSING CONFERENCE TO THE COMMITTEE ON FINANCE, THE UNITED STATES SENATE FOR INCLUSION IN THE RECORD OF THE HEARINGS HELD ON JULY 16, 1985 WITH RESPECT TO THE IMPACT OF THE PRESIDENT'S TAX PROPOSALS ON HOUSING, REAL ESTATE AND REHABILITATION

The National Housing Conference, the oldest national organization concerned with the provision of adequate housing and decent neighborhoods for all Americans, appreciates the opportunity to present its views on the President's Tax Proposals as they relate to housing, real estate and rehabilitation. This statement will focus primarily upon the potential impact of these proposals on the provision of rental housing, especially for the low and moderate income.

Enactment of these tax proposals would be tantamount to driving the last nail in the coffin containing the corpse of what, not too long ago, was a healthy, bipartisan Federal concern for encouraging the provision of decent housing for all our citizens. When combined with the Administration's Budget proposals for FY 1986, there would only be a skeleton left of the Federal commitment, contained in the Housing Act of 1949 and reaffirmed several times since then, to the goal of a decent home and suitable living environment for every Americen family. While significant progress has been made toward achieving that goal, many millions of Americans are still inadequately housed or are still paying outrageously high percentages of their incomes for housing.

The Tax Code, for at least the last three decades, has served as a major incentive for investment in real estate. This was not unique, as the Code has been deliberately used by the Federal Government to encourage other social and economic results deemed beneficial to the nation. And the Code would continue to do so, even if all the changes proposed by the President were to be enacted.

Over the years, provisions of the Code which encourage investment in real estate have been modified and adjusted to fit the perceived needs of that time and, where deemed appropriate, to cut back those provisions thought to be overly generous. However, in connection with the many changes, one thread has consistently been present in the decisions made by the Congress -- investment in rental housing, especially for the low and moderate income, continued to merit special treatment and encouragement. In fact, many of the special provisions of the Code now applicable to housing are residuals of provisions which formerly applied across-the-board to all real estate investment or, in the case of low and moderate income housing, to all housing investment.

In amending the Code over the years, Congress has recognized that investment in housing cannot compete equally with most other investments, either in real estate or otherwise. These residual incentives for housing would now all be dumped and eliminated. As Treasury Secretary Baker indicated in his statement before this Committee on June 11, 1985, a result, and presumably a goal,of the "President's plan" is "...a shift in the composition of investment toward more industrial and commercial structures and inventories". Nowhere in Secretary Baker's statement was there any recognition of what had been a 50-year special Federal concern for meeting the housing needs of the American people, except, with respect to the mortgage interest deduction, to pay obeisance to "the central importance of home ownership to values cherished by the American family". For those who cannot afford to buy a home, there was no concern shown.

It is the renters of America who will be most drastically impacted by these tax proposals. The ability of private enterprise to continue to meet the needs for additional rental housing for the low, moderate and middle income has become increasingly dependent over the last ten-twelve years on Federal support. Interest rates during most of that time have been significantly higher than the pattern of the thirty preceding years. This has had a major impact on rents, because of the heavy reliance on borrowed funds by most owners of rental housing.

Rents must be high enough to cover the mortgage. Yet, residential renters do not have the flexibility that commercial renters have to absorb rent increases. For a family, its rent is usually its largest single expense, often representing 25%, 30%, 35% or more of gross income. For a business, rent may be a major cost but it seldom represents anywheres near as large a share of income. Furthermore, the business is better able to pass on increased rental costs to its customers, than the family is able to increase its income so as to cover any increase in rent.

The only way in which rental housing has remained economically competitive in recent years with other investment alternatives has been either through direct Federal assistance, such as under the now terminated HUD

Section 8 and GNMA Tandem programs, or because of the availability of lower interest rates through IDB financing. In both instances, the other incentives in the Tax Code, such as accelerated depreciation, more liberal rules on recapture of excess depreciation, expensing or shorter-term write-offs of construction period interest and taxes, etc., have also been essential to achieve economic parity with other, less risky alternatives.

While interest rates have fallen somewhat in the last several months, they are still at a level of 12% to 13% for conventional loans, far too high in most instances to enable rental housing to be provided for anyone other than the upper middle income and the wealthy. If the President's proposals, to eliminate multifamily IDBs and all other tax incentives for investment in rental housing, are adopted along with his proposals to terminate or suspend for at least two years all forms of direct Federal assistance for low and moderate income housing, there would be no way that anyone would be able to meet what is still a major problem in the world's wealthiest nation -- the inability of many lower income Americans to obtain decent shelter at a cost that does not destroy their ability to take care of the other necessities of life.

NHC urges the Committee to weigh carefully our concerns about the impact of these tax proposals on the supply of rental housing, especially for the low and moderate income. We should also like to touch upon a few other points. First, is our continuing concern about the effect of last year's changes to Section 103 of the Internal Revenue Code on the financing and cost of public housing. As a result of those changes, a successful means of financing public housing, in place since 1937, has been jeopardized while HUD and Treasury continue to discuss at great length how to resolve the problem.

In the meantime, the Office of Management and Budget has seized upon the impasse as an excuse for proposing to expend almost $15 billion in Fiscal Year 1985 to buy out most of the loans presently financing public housing. At a time of great budget stringency and overwhelming concern about deficits, we do not understand why the Administration is so willing to increase the deficit by $15 billion, when seemingly minor legislative changes would resolve the matter. We urge the Committee to move expeditiously to resolve the matter and permit public housing to return to its proven financing means.

NHC also urges that the Committee, in considering the President's proposals, weigh the impact of those proposals on the ability of our nation's cities to achieve needed economic and physical rejuvenation. We urge that decisions, with respect to rehabilitation tax credits and the use of tax-exempt financing, factor in how these tax incentives, and others affecting real estate in general, are used to bring about needed revitalization, especially in conjunction with such programs as HUD's Community Development Block Grant and Urban Development Action Grant Programs.

Lastly, we should like to ask that the Committee deal now with a growing problem that is seriously disrupting the undertaking of long lead-time activities, such as most rental housing and other real estate transactions. As matters now stand, the President's tax proposals, if adopted, would be effective on January 1, 1986, except for properties placed in service prior to that date or, in the case of tax-exempt bonds, those issued prior to that date. As a result, many new projects are not being started because they cannot be completed and the property placed in service prior to the end of the year. In other instances where bonds are expected to be needed, such as for housing projects, those projects are not proceeding if it is anticipated that the normal pre-bond issuance activities may not be completed prior to the end of the year.

In effect, without a single action being taken by this Committee or the Congress, the President's tax proposals are in many instances already in effect. This is not the way in which we understand the legislative process is supposed to operate. We urge that some indication be given as soon as possible that, regardless of what final action is taken by the Congress on these tax proposals, those actions will not be effective with respect to housing and other real estate transactions and bond issues on which definitive actions have been taken by the involved parties prior to the action by Congress on legislative changes. Such an indication would restore certainty to the market place and allow the recommencement of normal activities in connection with long lead-time undertakings, such as most rental housing and other real estate transactions.

We have not dealt extensively with the details of the President's tax proposals, but rather have focused on the broad impact of those proposals. The National Housing Conference has established a task force to try to assess the many individual proposals advanced by the President and to come up with recommendations on them. Once these specific decisions are reached by NHC, we should like the opportunity to present them in writing to the Commiteee for its consideration, either as an addendum to this statement or separately. We would be pleased to work with the Committee and its staff to devise means of protecting housing from an unwarranted diminution of needed tax incentives.

National
Leased
Housing
Association
serving America's
rental housing needs
NLHA

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SUBMITTED FOR THE RECORD

STATEMENT OF

NATIONAL LEASED HOUSING ASSOCIATION

TO THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

HEARING DATE: JULY 16, 1985

IMPACT OF TAX REFORM PLAN ON HOUSING

The National Leased Housing Association is a unique organization representing both public and private sector organizations involved in providing affordable and badly needed rental housing for low and moderate income Americans. We number among our 800 members state housing agencies, local housing authorities, non-profits, developers, financiers, and managers. We are proud of our pioneering role in bringing public and private entities together to make better rental housing available for millions of Americans.

While other industry groups have addressed the specifics of the President's tax reform proposal as they relate to rental housing, NLHA would like to focus on some broad questions of housing policy for this country. Normally, these concerns are under the domain of the Committee on Banking, Housing and Urban Affairs, but this year this Committee will be making decisions that will have an indelible effect on the future of low and moderate income housing in this country.

At this time, the National Leased Housing Association has housing policy at the focus of its concern because we have just concluded our policy platform -- Rental Housing in Today's Reality -- a copy of which is attached for insertion in the record.

The platform reflects a rather unique position of an organization that has been very much development oriented during the fourteen years of its existence, as our cardinal tenent is that major emphasis should be placed on utilizing existing housing to house America's low income families. Although we do set forth instances where public policy requires the construction of new housing for low income people, overall we stress that the utilization of existing housing makes any scarce subsidies available go farther to help more low income families. This position parallels that of the Administration, although we do differ from the Administration in believing that Section 8 certificates, rather than vouchers, are the best way to house low income families utilizing existing stock.

There is an important predicate to this policy position that is most germane here -- that tax incentives for debt and equity formation for new rental housing must be preserved. In order for the existing housing stock to be utilized for low income families, there must be an adequate rental housing stock within a community. Even if rental housing is constructed for middle income families it frees up lower-cost, decent existing stock to be utilized by low income families under the Section 8 existing or voucher program. We believe that the rental stock in a community should be viewed as a totality and that everyone -- especially low income families -- will benefit when new rental housing is constructed.

If new rental housing is to be built, tax incentives must be continued. Recently, several studies by distinguished economists have indicated that under the Administration's revised tax proposal rents on newly constructed projects will increase in the 20-30 percent area. Indeed, NLHA has participated with other housing organizations in sponsoring a study by Wharton Econometric Forecasting Associates in conjunction with leading economists from Harvard and MIT which will confirm these figures.

The market cannot bear these rent increases, and as a result very little new rental housing will be constructed. Indeed, it appears that the Wharton study will forecast a decline of 160,000 rental units a year as a result of the Administration's proposal. As above emphasized, when no new rental housing is built in a community, then the existing stock cannot be used to housing low and moderate income families receiving subsidy assistance. Instead, the rent on the units will be bid up by middle income families making the Section 8 certificate or voucher useless. In addition, tax incentives are often necessary to enable owners to keep their existing rental property in good condition so it can be utilized by low and moderate income families.

Accordingly, for reasons of sound housing policy of utilizing our existing stock -- the very housing policy espoused by this Administration -- we believe it essential that tax incentives continue to make possible the construction of new rental housing and the maintenance of our current stock. These include the incentives for debt formation -- tax exempt financing -- as well as provisions encouraging equity formation, such as the present depreciation schedule, the exception from the "at risk" rules, the ability of a limited partner to deduct immediately construction interest and the like.

The above analysis teaches an additional lesson. Congress should not adopt too restrictive a definition of what constitutes

low income housing to qualify for either tax exempt financing or special equity formation benefits. As emphasized before, all in the community benefit from the construction of rental housing. Accordingly, in defining "low and moderate income housing" Congress should adopt a standard that would make these tax incentives available for a broad range of moderate income rental housing, although properly excluding upper income or luxury rentals.

In closing, let us respond to this often posed question: if the provision of low and moderate income rental housing is such a public benefit, why does not Congress do so through direct subsidy? Indeed, that point is made in the Administration's proposal justifying its termination of the Section 167(k) rehabilitation write-off. There are two answers to that question.

First, we are victims of a rather bizarre shell game. The Administration states that we should seek direct subsidies, yet submits a budget doing away with virtually all housing assistance programs. Although the budget resolutions of both houses have rejected such a draconian result, in this time of great budget stringency it is still most difficult to obtain anywhere near the needed amount of direct assistance to meet rental housing needs.

Second, assistance through the Internal Revenue Code comes with much less administrative red tape than do direct subsidies. By and large, tax law restrictions are enforced without a large government administrative mechanism. Instead, developers and their counsel, upon great penalty must certify that a particular project complies with rules governing the issuance of tax exempt bonds and syndication. These rules are zealously enforced without the need for government intervention.

Thank you for your consideration of these issues.

RENTAL HOUSING IN TODAY'S REALITY

The Housing Platform
of the
NATIONAL LEASED HOUSING ASSOCIATION

National
Leased
Housing
Association
serving America's
rental housing needs
NLHA

May 1985

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RENTAL HOUSING IN TODAY'S REALITY

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EXECUTIVE SUMMARY

The National Leased Housing Association is a unique combination of public and private entities (local housing authorities, developers, state housing agencies, housing financiers, non-profits, etc.) involved in providing rental housing for those of low and moderate income. At the same time that national priorities must be reexamined in view of financial stringencies, the nation is faced with severe rental housing needs, especially for lower income families. It is estimated that between 600 to 700 hundred thousand new rental units are needed annually to meet rental housing needs.

To meet the housing needs of low income families, the major emphasis should be on utilizing our existing housing stock. This choice is dictated by the high cost of providing new housing for low income families, and the current political aversion to paying such costs in a time of budget stringency. The optimum method of utilizing existing housing is the Section 23 Leased Housing Program, under which the owner enters into a lease with a local housing authority who in turn subleases to the tenant. In any event, the Section 8 Existing program is far superior to the utilization of housing vouchers, as Section 8 Existing limits the percentage of income a tenant can pay for rent as well as the rents received by owner. Any program utilizing existing housing should have enforcement of housing quality standards as a central facet, a function best performed by local housing authorities.

Although major emphasis should be placed on utilizing existing housing, there are circumstances that justify new construction or substantial rehabilitation for low income needs. This is true where no existing housing stock exists to accommodate needy tenants, such as in rural areas, or where building new housing for the elderly will free up larger older homes for large families, or generally where housing for large families is not in sufficient supply. Likewise, the construction of new housing for low income families is justified as part of a locality's economic revitalization program as well as in growing suburban locations where no lower income housing is available.

We do not recommend any specific program to get such housing built, although useful tools would be Housing Development Grants (HoDAGs), utilizing community development block grant funds for new housing production, the new construction aspect of the Section 23 Leased Housing program, and creative use of HUD-FmHA multi-family mortgage insurance.

Vital for new rental housing production is the continuation of tax incentives. We view as misguided current proposed changes to the Internal Revenue Code that would effectively do away with equity syndication for multi-family housing as well as the availability of tax exempt industrial development bond financing for housing. Without these useful tools, rents would have to rise 63% to induce the construction of new rental units. Since such increased rents could not be readily paid, the result would be the virtual elimination of new rental housing. Housing produced as a result of tax incentives is not necessarily low income housing. However, the public at large benefits from an increase in the entire rental housing stock. If there is to be a successful use of existing housing for lower income people, there must be a totally adequate supply of housing within the community at large.

The effective management and preservation of our existing rental housing should be a matter of prime national concern. An essential ingredient of preserving existing government assisted rental housing is the allowance of realistic rents so that the property can be adequately maintained. Fair management fees are also necessary to provide incentives to continued good management. There should be minimum federal intervention in daily management issues, such as whether or not pets should be allowed in assisted housing projects. However, one overriding federal role, that of fair housing law enforcement should be continued, and indeed strengthened. The federal government should, furthermore, make resources available to preserve existing housing through low interest loans to owners to make necessary capital improvements and generally to keep the units in good repair.

RENTAL HOUSING IN TODAY'S REALITY

The Housing Platform
of the
NATIONAL LEASED HOUSING ASSOCIATION

NLHA - Who We Are

The membership of the National Leased Housing Association -- private and public owners, managers and financiers of rental housing -- uniquely exemplifies the public-private partnership that has produced needed rental housing in America over recent years. This partnership is American ingenuity and pragmatism at its best: a joint effort between the private and public sectors to improve the quality of life for all Americans. Such a partnership is essential because housing is more than four walls and a roof. Housing means an affordable, decent home in a pleasant neighborhood environment, with access to jobs, amenities, and schools and the network of opportunities that enhance life for all our citizens. In this sense, decent rental housing, unlike virtually every other product that fuels the U.S. economy, cannot be developed without the concerted coordinated action of lenders, developers, local government, public housing agencies, underwriters, and community groups. All of these find a common purpose in the Association, which is dedicated to public programs and private initiatives that will strengthen this ongoing partnership.

Housing Policy at the Crossroads

A great majority of Americans are among the best housed people in the history of world civilization. A substantial number of families in the United States today live in physical settings that three generations ago would have been home only to a privileged few. This great achievement should be a source of pride but not complacency.

In the Housing Act of 1949, the Congress issued a Declaration of National Housing Policy, a challenge to the nation to realize "as soon as feasible the goal of a decent home and a suitable living environment for every American family . . . ." Enormous progress has been made in striving toward that goal. But it bears remembering that our national goal does not say that we are trying to achieve a decent home for "every American family who can afford it." Much remains to be done to fulfill the promise of that goal for a large segment of our population for whom it appears, even now, to be a vanishing dream.

Over several decades, a variety of tools to achieve this goal has been fashioned at the federal level. Federal programs have responded to felt needs and changes in the economy, tax laws, credit and housing markets, and demographic patterns over time. In a nation as vast and heterogeneous as the United States, with an economy as complex as the world has ever known, and with a federal system knitting together an intricate fabric of governance, no single program can be devised that will by itself effectively carry out our national housing policy. Our approach as a nation has been pragmatic; many programs have been tried, some with greater success than others. In many cases, success has fallen prey to a change in national priorities, and effective programs have been underfunded or interrupted or dismantled.

We are again in a period when national priorities -- deficit reduction and tax reform or simplification -- threaten irreparably to undermine our commitment to this national housing policy. Some of this damage may be inadvertent. On the other hand, some opponents of the national housing policy are seizing the opportunity provided by the current environment to destroy policies they have always opposed. (There are, after all, those who would wish to eliminate federal housing programs even were there a $200 billion dollar surplus.) What has been built up over decades with considerable positive result ought not to be lightly cast aside without a deliberate conscious weighing of alternatives and the potential damage to our social wellbeing.

Over the past five fiscal years, federally assisted housing programs have suffered a reduction of 55% in new units assisted, 68% in new budget authority, and 83% in the number of new units reserved for new construction substantial rehabilitation -- possibly the deepest cuts incurred by any of the domestic programs. Now even further reductions are proposed in direct subsidies and the Treasury Department has proposed the elimination of existing tax incentives that, together with subsidies, provide the remaining sustenance for a bare minimum of needed rental housing.

The NLHA believes that this crucial time of general re-examination of housing programs provides the appropriate occasion for a realistic appraisal of the tools and programs by which our national housing goal should be achieved in the light of decades of experience and the needs that will confront the nation in the foreseeable future.

As before emphasized, NLHA uniquely combines both the public and private skills necessary to provide decent rental housing in this country. For that reason, its emphasis since its inception has been on those housing programs that involve a private-public partnership, such as the Section 23 Leased Housing Program where the local housing authorities lease units from private landlords, the Section 8 program where the local housing authorities provide housing assistance funds to private landlords, and today, projects financed by tax exempt bonds issued by state and local agencies. NLHA serves its public members best when we provide an opportunity for interaction and interchange with private sector participants in the multi-family sector, an arrangement that is reciprocally beneficial to its private members.

Accordingly, this platform will not focus on programs strictly public in nature, like the public housing program. This in no way indicates NLHA's lack of support for this very basic subsidized housing program, which provides decent housing for over a million low income families, but merely reflects our focus on programs that involve continuous interaction between both public and private sectors.

Rental Housing Opportunities and Needs

The success achieved since 1933 in housing the more affluent among us should not obscure the fact that for too many Americans the reality of an affordable decent, safe and sanitary home is still elusive. A few statistics will suffice to shake any complacency regarding results of our national efforts for a large portion of our population:

o The nation is dividing into two groups: lower income households who rent housing, and middle- and upper-income households who own housing. In 1970, the average renter household income was 65% of the household income of the average homeowner. By 1980, the average income of renters compared to owners had dropped to 53%, and the gap is still widening. The income of renting households clearly is rising more slowly than that of homeowning households, and this is severely limiting the affordability of rental housing.

o In 1973, renters were devoting an average of 22% of their incomes to the cost of rent. seven years later, that figure rose to 29%, a substantial increase. This figure reflects the "graduation" of many higher income renters to homeownership, leaving lower income households in the rental market. Of over 10 million very low income households, over 7 million now pay more than 30% of their income in rent: and over 2 million households pay over 50% of their income in rent.

o According to a recently released Survey of Consumer Finances undertaken by the Federal Reserve Board, the percentage of U.S. families owning homes dropped from 65 to 60% between 1977 and 1983. In the same period for low income families, the homeownership level dropped from 43% to 36%, a precipitous decline. The drop in the national ratio of homeownership in the past few years has been so dramatic, in fact, that it has literally wiped out more than half of the homeownership gain achieved during the prior ten years. In effect, the last 10 years has seen almost no progress in homeownership at all. Rental housing is thus of increasing importance and will remain home for a growing segment of our population.

o The 1980 Census shows that over 5.1 million American families live in substandard housing. Of this 3.290 million are in rural areas, emphasizing the special housing needs outside our metropolitan area.

o The proposed tax changes forwarded by the Treasury Department in November 1984 would exacerbate the already bleak rental housing situation. According to a study undertaken by the National Association of Homebuilders, if present tax incentives for equity syndication in rental projects are removed, rents would have to increase by 42% to induce the construction of new rental units. If, in addition, tax exempt financing for such rental units is taken away, rents would have to rise 63% to induce such construction.

Although the Treasury proposal would take away the tax incentives for rental housing, it would not remove the deductibility of homeowner interest. We endorse the present policy of interest deductibility to promote home ownership, but simple fairness demands that Federal policy must also even-handedly address the needs of non-owners, whose economic and housing conditions have worsened materially in recent years. There must be rough equivalence in the resources -- both through tax incentives and direct subsidies -- devoted to the needs of renting households compared to the assistance given to owner-occupants. We should continue homeowner tax incentives and likewise those incentives that benefit renters.

Some economists have claimed, quite erroneously, that the housing sector of the U.S. economy consumes "too much" capital. This is simply not true. The share of funds in the capital markets devoted to housing has actually been declining rapidly, from an average of 32.5% in the 1950's to 27.5% in the 1970's, to 21.9% in 1982. Housing has lost its former position as a preminent opportunity for debt investment as a result of competition from corporate America (and the U.S. Treasury) for capital. Lenders do not like to use one-day money for long term loans. What housing finance has required and still requires because of its dependence on long term financing, is an opportunity to compete on a level playing field with short term capital demands that can pay high and volatile interest rates and pass such costs onto the consumer. Housing credit shortages and high mortgage interest rates have not been created by housing demand but by competing capital demands generated from other parts of the economy, from which housing is no longer sheltered.

Apart from present needs, the demand for housing, and rental housing in particular, will grow substantially in the foreseeable future. Most demographers expect new household formation during the 1980's to be in the range of approximately 15 million, about 15% less than in the 1970's but high nonetheless. The increased demand for new rental units to accommodate new households and to replace units that are withdrawn from the inventory will approximate 600,000 to 700,000 per year according to the most conservative estimates. The supply of new unsubsidized rental units is falling far short of that demand on a national basis. As will be emphasized throughout this platform, the production of unsubsidized rental housing is essential not only to house middle class renters, but to free up decent existing rental stock to be utilized by lower income families receiving housing assistance. Finally, the supply of new subsidized units, now about 50,000 annually, is woefully short of need, and even this amount would be cut to zero under the Administration's budget proposal.

Housing needs are thus generated by the sheer growth in our population and the persistence of low incomes; in other words, inadequate supply and inadequate income are the facts of life that housing policy must confront.

Private enterprise is responsible for most new rental housing developed in the United States. By contrast, new investment in private unsubsidized rental housing is essentially nonexistent in Britain and Europe, except for luxury housing. These highly developed nations have made housing among the most regulated of activities, heavily dependent on subsidies and complicated approval processes. This system resulted from a shortage of housing resources, which forced a form of rationing (that is, governmental distribution of resources) in those economies. Unless sufficient resources are made available in this country for private enterprise to continue to meet pressing housing needs, with and without subsidies, the same results will occur here. Assuring sufficient resources and subsidies for private enterprise to meet today's housing needs is a wise investment to assure that tomorrow's renters will not have to depend on political decisions for all their housing needs.

Our Policy

With this background of who we are and where we are, let us proceed to the specifics of what rental housing policies are needed at this time.

I. MAJOR EMPHASIS SHOULD BE PLACED ON UTILIZING EXISTING HOUSING TO MEET OUR LOW INCOME NEEDS

Any housing market that is not experiencing explosive growth consists overwhelmingly of older existing housing. The vast majority of Americans live in housing that is "used." Access to adequate and affordable existing housing should thus make the major contribution to achieving the goals of national housing policy. The most direct method of attacking problems of affordability will be through the use of older existing housing, providing assistance for renters in the private market. The subsidy per unit is less and tenants can exercise choice in the market if properly counseled.

Assuming the emphasis on existing housing as a major source of meeting our lower income needs, the question remains, what is the most efficient way to utilize the existing housing stock? Since 1974 HUD has been utilizing the Section 8 Existing housing program as a delivery mechanism. Under that program, the tenant enters into a direct lease relationship with the landlord at or under a HUD-mandated fair market rent. The difference between that fair market rent and percentage of income the tenant is required to pay -- curently 30% -- is subsidized by housing assistance payments from the local housing authority utilizing federal funds. NLHA believes that the Section 8 Existing program has generally been successful, due in good part to the administrative role played by the local housing authorities.

Before the advent of the Section 8 Existing program, however, the government utilized another mechanism for subsidizing existing housing -- the Section 23 Leased Housing Program. Under that program, the local public housing authority (PHA) leased the unit from the landlord and subleased it to the tenant. Accordingly, the PHA was an intermediary between landlord and tenant. The PHA in its capacity as tenant was able to negotiate favorable leases, due in good measure to the fact the landlords often would rather deal with the PHA as a tenant than a low income family occupant, and also due to the greater bargaining sophistication of the PHA. This arrangement proved beneficial to the tenant as well. Instead of having to deal with a private landlord, the occupant tenant dealt with the public landlord -- the local public housing authority.

For that reason, NLHA believes that the Section 23 Leased Housing Program is a better mechanism to utilize existing housing than the Section 8 Existing program. We call for its return. No matter what existing housing program is utilized, it should be funded by Congress at a significant level in light of the pressing needs of low income families.

Although we may prefer Section 23 to Section 8 Existing, we very much favor the Section 8 Existing over the voucher program advocated by the Administration. Under the voucher program, there is no limit to the rent the landlord can receive or to the percentage of income the tenant can pay. Accordingly, tenants will be paying a disproportionate percentage of income as rent and landlords could well be receiving undeservedly high rents. These are precisely the evils a well-administered existing housing program should avoid.

One essential element of any program utilizing existing housing is that there be adequate housing quality standards that each unit in the program must meet. Otherwise, the government will be using its resources to subsidize slums. Of course, if there are standards, there must be enforcement. And that is the essential role of the local housing agency in administering the program. For that reason, NLHA is unalterably opposed to any welfare type housing allowance program that does not have housing quality standards enforceable by a local housing authority.

Further, if the PHA is to assume this crucial role of enforcing quality standards, as well as its other essential roles in administering the program, it must receive adequate compensation in the way of administrative fees. NLHA thus strongly opposes pending attempts by the Department of Housing and Urban Development to reduce fees from the current level that barely provides enough operating income to the PHAs to administer the program.

Assuming the retention of the Section 8 Existing program, the PHA administrative fee system should also be designed to encourage mobility of tenants from one PHA jurisdiction to another without jeopardizing the fees earned by the original PHA. Although housing authorities should be encouraged to participate in a mobile certificate program, they should do so on a voluntary basis, taking into account the availability of local resources. Further, our experience has shown that use of the certificate outside the area of the issuing jurisdiction works out far better on an intra-state rather than an inter-state basis.

There is much existing stock that is in decent condition and can be utilized without further rehabilitation. In addition, there is existing stock that is not presently habitable, but can be made so with relatively minor expenditures. HUD, in the past has encouraged this endeavor, through the Section 8 moderate rehabilitation program and the rental rehabilitation grant program. Consistent with our emphasis on utilization of exising stock, NLHA strongly favors programs directed to the moderate rehabilitation thereof when necessary, as moderate rehab has proven an economical way to meet the housing needs of low income families.

Some existing stock has so deteriorated that it can only be made serviceable through significant expenditures. This is known as substantial rehabilitation. Generally, the cost of substantially rehabilitating a unit nears that of a newly constructed unit and under past housing programs, they have been categorized together. Accordingly, when in Section II we outline areas where housing production for low income families should be part of the national policy, such production can be accomplished either through new construction or as substantial rehabilitation. Local conditions, primarily the existence of rehabilitable stock, should dictate the method to be utilized.

Our advocacy of full use of existing housing rests on a very essential premise -- that an adequate supply of new rental housing will be produced. There simply cannot be a workable program utilizing existing housing unless there is an adequate supply of rental housing within each housing market. To achieve our social goals it is not necessary that all such rental housing be produced for low income families. Low income families benefit from production of rental housing they cannot afford because it frees up the availability of rental housing they can afford. For that reason, NLHA supports those provisions of the Internal Revenue Code that lead to the production of rental housing of any type (see Section IV).

II. ALTHOUGH EMPHASIS SHOULD BE ON EXISTING HOUSING, THERE ARE CIRCUMSTANCES THAT JUSTIFY NEW CONSTRUCTION FOR LOW INCOME NEEDS

If experience has taught any lesson, it is that a concentration of subsidies on production for low income families rather than on better use of our existing housing stock would be misguided. But a balanced view must be taken on this issue. In recent years, criticism has been leveled at programs that have subsidized newly constructed housing for lower income households. In general, critics have charged that: (a) the cost of assisting a household in a new unit is substantially more than assisting the same household in an existing unit; (b) because of such high costs relatively few households among those eligible actually obtain benefits; and (c) the minimum property standards applying to newly constructed subsidized housing assists lower income households to obtain better housing than unassisted taxpaying households in the same neighborhood or community.

These criticisms may have merit but ignore the reality that any rational and comprehensive approach to meeting our society's housing needs will require continuing subsidies for newly constructed or substantially rehabilitated housing for lower income occupants for the following reasons, which reasons should provide the basis for targeted production subsidies in the future:

1. In many markets, there is simply an inadequate supply of existing rental housing for those in need. Fast growing suburban areas provide one example. Rural areas are especially needy in this regard, fully justifying continuance of the Section 515 rural rental housing program. Concentrating subsidies on existing housing in such areas of shortage would simply bid up the price of the existing supply.

2. In many markets, the introduction of new housing for the needy elderly can free up the existing inventory of large under-occupied homes for larger families. This is a prime justification for the continuance of the Section 202 elderly program.

3. Units for very large poor families are typically in short supply in most markets, and existing housing does not readily accommodate the needs of such households. The same holds true for the special needs of the elderly and the handicapped.

4. Localities involved in comprehensive economic development programs, which revitalize deteriorated urban areas, should be able to rebuild or revitalize such areas for a wide range of households and incomes, not simply for the affluent. This will require subsidies for new housing production for assisted households in areas undergoing redevelopment. Such projects provide opportunities for economic integration that can be achieved in no other way.

Let us stress the importance of revitalization as a social goal. Formerly underdeveloped land in our central cities can prove a real asset in turning around a city's economy. To accomplish revitalization, as we have emphasized, direct subsidies are needed for housing and other development activities. Assuming that such direct subsidies (i.e., Urban Development Action Grants, Housing Development Grants, etc.) are available, then the tax incentives contained in the Administration's Enterprise Zone proposal could prove a valuable addition. However, if the choice boiled down to retention of direct subsidies, or passage of Enterprise Zones, NLHA would strongly favor the direct subsidy programs, because the indirect subsidies contemplated for the Enterprise Zones cannot do the job alone.

5. Growing suburban localities that have adopted, voluntarily or involuntarily, an inclusionary housing and land use policy should be enabled to have a balanced housing policy that provides opportunity for access to jobs and schools for an economic and racial cross-section of the housing market. Our nation can ill afford to lock lower income people into the central city, an inevitable result of the suburban rental housing shortage discussed above.

These goals refine the purposes of targeted production programs in ways that justify the additional costs involved. We believe that such production programs co-exist well with a subsidy policy that operates primarily within existing housing.

Frequently, housing policy making at the national level lags behind reality. Because of the undoubted overbuilding of multi-family rental housing that occurred ten years ago, the perception is strong among national policymakers -- many of whom are not familiar with housing -- that subsidies that add to new inventory will inevitably contribute to an oversupply. In fact, an oversupply of multi-family rental housing no longer exists in most housing markets, and the insertion of subsidies for production in such markets will not create undue vacancies, although recent experience in Houston and elsewhere has shown that an abundant rental housing supply does mean lower rents. Clearly, however, it will be necessary to assure that in any given market government subsidies do not contribute to overbuilding.

and recent experience with the Housing Development Action Grant program demonstrates that this criterion can effectively be built into a new construction program.

There is thus a complementary role to be played by effective use of newly produced housing and existing housing in carrying out a national housing policy, and it would be profoundly wrong to rule out one approach in favor of the other as a dogmatic prescription for the future.

III. DIFFERENT PROGRAM APPROACHES SHOULD BE UTILIZED IN CONSTRUCTING HOUSING FOR LOW INCOME PEOPLE

In those cases outlined in Section II above where it is proper to produce new rental housing for low income families, there should be a variety of program approaches. The Section 8 new construction program and substantial rehabilitation programs did result in a significant number -- over 750,000 -- units being produced for low income families. However, it seems doubtful that today's financial stringencies will allow a return to the Section 8 deep subsidy concept in the near future. Traditional public housing also is an effective way to build housing for low income people; but it has faced both local and national political opposition over the years, making its future highly unlikely as a mass production program. There are circumstances when the traditional public housing program best meets the needs of a local community and federal subsidies should continue to be available.

Other methods to provide newly constructed housing for low income people would include utilizing the following tools:

A. HoDAGs

We strongly endorse the continued funding at existing or increased levels of the Housing Development Grant program (HoDAG) under rules that improve program feasibility. Patterned on the highly successful Urban Development Action Grant Program, the HoDAG program meets the criteria that should govern the use of subsidies for housing production set out above. Initial reaction to the program was promising, and it should be given the opportunity to mature into a full partnership between local government and private entrepreneurs. The federal grant agreement under this program should be revised to reflect the realities of private development timing and economics to assure that federal assistance is injected into the project when it is most needed.

B. CDBG for Housing

We endorse changes to the Community Development Block Grant program (CDBG) that would permit CDBG funds directly to subsidize new construction. Most of the innovative uses of CDBG funds have been developed and implemented at the local rather than the federal level. Local initiatives can best respond flexibly to local needs, and a variety of successful housing rehabilitation efforts have been mounted in localities across the country. Yet, new construction is one of the few housing-related activities not permitted under the CDBG program except in certain special instances where nonprofit groups are involved. The time has come to unleash the ingenuity of local programs and to allow CDBG funds to be invested in new housing regardless of the nature of its sponsorship. Such a change will greatly enhance the local opportunities for successful innovation under the HoDAG program.

C. Section 23 for Housing Production

Another effective way of building new housing for low income people is the Section 23 Leased Housing Program. We have outlined before how it can be effectively utilized by the local housing authority to rent existing units. When the program was in operation in the late 1960s and early 1970s, the Section 23 mechanism was also utilized effectively as a financing support for construction of new housing. A local public housing authority (PHA) agreed to rent all of the units of a newly constructed or substantially rehabilitated project from a developer landlord. On the basis of that lease, backed up by an HUD annual contributions contract, the owner could secure long term financing for the project. The PHA would then sublease the units to the tenants thereby preserving the advantage of a direct PHA-tenant relationship. This proved to be a most effective mechanism for the development and financing of low income housing.

D. HUD-FHA Multi-Family Mortgage Insurance

Although FHA insurance by itself does not significantly bring down interest costs, there are innovative multi-family insurance programs that could be helpful in reducing monthly interest payments in the early years to make the project more feasible. They include graduated payment multi-family mortgages, shared appreciation and balloon mortgages that Congress authorized in the Housing and Urban-Rural Recovery Act of 1983. These techniques should be part of any developer's tool kit in obtaining realistic financing for new rental housing.

IV. TAX INCENTIVES FOR DEBT AND EQUITY FORMATION FOR RENTAL HOUSING MUST BE PRESERVED

We strongly favor the continuation of tax incentives under the Internal Revenue Code for the development of rental housing. Congress, since 1968, has recognized the importance of stimulating private entrepreneurs to participate in meeting national housing needs by creating special tax incentives for such activity. This favorable treatment is intended in part to compensate for the limitations on rental income that are imposed on owners of lower income rental housing subsidized directly or indirectly under federal programs. In most of these programs, the private owner's cash profit is limited by law or regulation, and additional controls or requirements are imposed with respect to rent levels, adjustments to rent, relationships with tenants, convertibility of the project to condominium or cooperative ownership, and similar matters. Such regulation, in the absence of other incentives, would make such programs unattractive in comparison to other forms of real estate investments. Even without such limitations, market restraints effectively limit the amount of rent that low and middle income tenants can pay. Accordingly, favorable tax treatment (such as accelerated depreciation, immediate deduction of construction interest, etc.) necessary to induce private entrepreneurs to engage in the development of rental housing, particularly subsidized rental housing, has effectively improved the owner's rate of return to make up for the limitations on real cash flow from the project and its lower rate of anticipated appreciation.

Especially needed are tax incentives to maintain our existing housing stock. Amendments added to the Internal Revenue Code in 1984 discouraging transfer of older assisted projects to new owners who would revitalize them are particularly unfortunate in that regard. Little acknowledgment has been given to the fact that tax shelter is people shelter as well.

In addition, tax exempt bonds issued by state and local agencies, such as local housing authorities, have become a major source of below market rental housing finance, which has made rents affordable for thousands of needy households. These bonds have financed billions of dollars of multifamily rental housing for mixed income occupancy and have added critically needed housing to many areas that would otherwise have experienced dire shortages and spiraling rents. The Treasury Department proposal would discontinue tax exemption for housing bonds but continue it, for example, for sports and circus arena bonds. We believe it is at least as important to house our people as to entertain them. The elimination of tax exempt housing finance would destroy one of the most effective tools ever developed for affordable rental housing. We strongly urge the retention of this needed financing tool.

In their role as issuers of tax exempt bonds, state and local agencies should not be merely passive actors issuing bonds at the behest of developer or financier without satisfying themselves that a social purpose is being served. In addition, we think it is totally proper for a public issuer to be concerned with such a matter as income limits, displacement policies and the like and to impose reasonable requirements beyond those mandated by federal and state law. However, before imposing such requirements public agencies should keep in mind the difficulties in structuring a financially feasible rental housing project and the financial practicality of any additional constraints.

Public housing agencies, as issuers of tax exempt bonds, should have the right to issue such bonds under the exemption provided in Section 11(b) of the United States Housing Act of 1937, as opposed to Section 103 of the Internal Revenue Code. At least until the passage of the 1984 amendments to the Internal Revenue Code, the Department of Housing and Urban Development was able to regulate the housing issuances under Section 11(b) without involvement of the Department of the Treasury. This proved an advantageous procedure, as HUD was sensitive to the specialized housing questions involved in housing bond issuance. Accordingly, we believe that the Internal Revenue Code should be amended to permit housing bonds to again be issued under this special housing tax exemption issuance provision contained in the United States Housing Act.

Likewise, we believe that public housing agencies should retain their right to issue tax exempt bonds to finance the production of new public housing projects. Accounting for public housing production as a direct budget charge in one year, as proposed by the Administration, causes an unrealistic short term expense item in the federal budget; in today's budget cutting atmosphere, the inevitable result is that no new public housing will be produced.

In theory, overt direct subsidies rather than the tax incentives could promote the development of needed rental housing. The Administration's budget recommendations show this to be wishful thinking. It is no more likely that direct subsidies will be available to do the work of tax incentives for rental housing than that such subsidies would replace the tax incentives for homeownership. Accordingly, we strongly oppose changes to existing incentives that operate to stimulate the development of rental housing.

As emphasized earlier, if the only governmental assistance were available through tax incentives, then it would be very difficult for any project to house 100% low and moderate income families. However, as we have stressed the public at large benefits from an increase in the rental housing stock. If there is to be successful use of existing housing for low income people, there must be a adequate supply of housing within the community at large. If not, those more able to afford higher rents will bid up the price of the available stock, thereby shutting out low income families and making any Section 8 certificate or voucher worthless. Accordingly, tax incentives for the production of rental housing in general inevitably benefits low and moderate income people in particular.

V. THE EFFECTIVE MANAGEMENT AND PRESERVATION OF OUR EXISTING RENTAL HOUSING SHOULD BE A MATTER OF PRIME CONCERN

The NLHA for several years has emphasized management concerns relative to our low and moderate income rental stock. Because of budget cuts already incurred, it appears certain that in the next few years there will be relatively little new housing construction for low and moderate income families. If the proposals forwarded by the Treasury Department in November 1984 are adopted, effectively eliminating tax exempt financing and equity syndication, there will be virtually no new rental housing at all for the foreseeable future. For that reason, it is essential that emphasis be placed on preserving our existing stock. This entails the following specific recommendations.

A. Allowing Realistic Rents and Fees

HUD, in any program that it administers, should permit rent increases sufficient to provide for the proper long term maintenance of the project as well as short term operation. Specifically, in the Section 8 program, HUD should not use the rule of rent comparability as a club to keep annual rent adjustments at a unsatisfactorily low level. In addition to insuring incentives to maintain the property, HUD should permit management fees comparable to those allowed in the private sector, adjusted to take into account the additional paperwork and other burdens associated with managing government assisted housing, as well as a fair profit return to the owner. These sound like truisms, but they are often ignored in the penny-wise pound-foolish government limitations and restrictions faced by owners and managers.

B. Minimum Federal Intervention in Daily Management

The federal government should leave as many management matters as possible to local discretion. Indeed, nothing is more local than real estate. Each community has different rental housing needs and ideas on how to meet these needs.

There have been recent examples of misguided federal attempts to regulate strictly local matters. The most notorious is Section 227 of the Housing and Urban-Rural Recovery Act of 1983 mandating that owners of projects for the elderly and handicapped must allow their tenants to keep pets. This law has caused a panoply of problems for project owners involving significant additional operating expenses, security threats to the project and a basic unfairness to the vast majority of elderly people who do not want pets and to the many of those who are allergic to them. For the Congress of the United States to legislate in such an inherently local matter is federalism turned upside down. We call for the speedy repeal of this provision.

C. Strong Enforcement of Fair Housing

There is one overriding federal regulation in which we firmly believe; equal housing opportunity as embodied in The Fair Housing Act of 1968. NLHA urges vigorous federal enforcement of its provisions and calls for further legislation giving the government more effective and expeditious enforcement rights.

D. Preserving Existing Housing

The federal government should make resources available to preserve existing housing. One example of proposed legislation which would do that is the Multi-Family Housing Preservation Act of 1985, which would provide a revolving loan fund to project owners to make capital improvements required to maintain such projects in decent, safe and sanitary condition and to maintain the low and moderate income character of such projects. Actually, such a program could ultimately save the government money by helping to prevent defaults on FHA-insured projects.

E. Meeting Other Social Needs

The ongoing provision of housing cannot be viewed in isolation from the other social needs of the tenants. Employment, education and health are of great importance to the low and moderate income tenants of assisted housing projects. In the past, housing agencies have performed in exemplary fashion in attempting to address some of these needs through special educational, job and health programs. NLHA favors such a broad gauged approach. Our only concern is that PHAs or owners engaged in such programs be provided the resources with which to carry them out. With current budget constraints there is not enough money in the housing budget to pay for these non-housing services. They must be funded through some other avenue. Nor should they be charged as a "housing expense" to make the cost of providing shelter appear unreasonably high.

These are just a sample of the management concerns on which we have concentrated during the past several years. NLHA plans to give increasing attention to management in the years ahead, so that our precious low and moderate income stock can be preserved.

VI. LOCAL REGULATIONS HARMFUL TO THE PRODUCTION OF RENTAL HOUSING SHOULD BE ELIMINATED

Every study commission that has examined the impact of local regulation on our housing needs has urged that local governments remove land use controls that unreasonably (or unconstitutionally) inhibit multi-family rental development, particularly for lower income households. Although progress has been made in some jurisdictions, discriminatory regulation remains a serious problem. Local laws also need to be modified to permit more efficient use of large, older homes for more than one family use consistent with reasonable health and safety standards.

Conclusion

The strength of NLHA is its diversity. We are unique among housing organizations because of our broad scale of participation from both the public and private sectors. Our members from every sector of the housing community have a vital role to play in providing decent rental housing for low income families in the years ahead. Although the missions of the different actors cannot be segregated with mathematical precision, the following is a broad outline of appropriate roles:

-- Public housing agencies, both state and local, can play a vital role as a housing catalyst through their ability to issue tax exempt bonds to finance rental housing. In addition, PHAs will play the crucial role of administering the Section 8 existing program and the needed revival of the Section 23 Leased Housing program. Of course, PHAs will continue to manage projects they own -- public housing and Section 8s, and to the extent funds are available, they will develop new public housing.

-- Our non-profit members play a similar role as housing expediters. Many of them are sophisticated developers who find a way to build or rehabilitate projects that are unattractive to the strictly private entrepreneur. To accomplish this end, many of our non-profit members are using sophisticated private sector techniques such as syndication. We certainly applaud this entrepreneurial activity and urge HUD to permit feasible public-private syndication of PHA owned projects.

-- Our developer members will be called on to get rental housing built and rehabilitated in an era when deep subsidies are unavailable. In Section III, we set forth a panoply of programs that can creatively be utilized. Of crucial importance for our developer members is the retention of the existing tax incentives for the construction of rental housing.

-- Our financier members face another difficult task, that of assuring that permanent financing is readily available for rental housing projects. Even assuming continuation of tax exempt financing, financiers must continually develop new techniques to make their bonds saleable in an investment climate not conducive to long term financial commitments. In addition to creative techniques dealing with bond maturity, the financier community will be called upon continually to devise new credit enhancement techniques.

-- Finally, our public and private managers will be facing increased challenges in the years ahead. National budget concerns adversely affect management resources for federally assisted housing projects. Our managers will be asked to perform more tasks, often for inadequate compensation, and this will cause administrative tensions. More resources and emphasis must be placed on training and other means to assure an ongoing, competent management profession.

We have faith that all sectors of our membership can perform these roles well. With a continued national commitment to decent shelter for all, we pledge to be of major assistance in assuring that every American, regardless of income, enjoys a decent, safe and sanitary home in a suitable environment.

NATIONAL LEASED HOUSING ASSOCIATION:

WHO WE ARE

The National Leased Housing Association is the only national organization serving all major participants in the rental housing field. NLHA is the respected voice and effective advocate for more than 800 member organizations, including developers, owners, managers, public housing authorities, state housing finance agencies, local governments, investment bankers, attorneys, accountants, architects, non-profit sponsors and syndicators involved in government related rental housing. This unique coalition is committed to public and private sector interaction as the most pragmatic means of meeting the nation's rental housing needs. Though NLHA's constituencies are many, its goal is one: the provision and maintenance of decent, affordable rental housing for all Americans, particularly those of low and moderate income.

Incorporated as a not-for-profit corporation in the District of Columbia, NLHA consistently provides its members with timely, sophisticated information and a powerful and respected voice in the councils where national housing policy is developed and where program and funding decisions are made.

Donna Denman	President
Lane and Edson, P.C.	Counsel
Janet S. Charlton	Executive Director

NATIONAL REALTY COMMITTEE **NEWS**

For release: Embargoed until 9:30 a.m.
Tuesday, July 16, 1985

Contact: Susan M. Vadney
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TAX PROPOSALS COULD SHARPLY RAISE RENTS, DEPRESS REAL ESTATE VALUES, REAL ESTATE GROUP TELLS SENATE FINANCE COMMITTEE

WASHINGTON, D.C., July 16 -- The National Realty Committee (NRC), in testimony today before the Senate Finance Committee, warned that key provisions of President Reagan's tax reform proposal could increase housing rents by almost 25 percent and commercial rents by as much as 32 percent while causing economic injury and increased unemployment in real estate and related industries.

J. McDonald "Don" Williams, Chairman of NRC and managing partner of Trammell Crow Company, told the Senate Committee that key provisions of the proposals will "tilt the game against real estate," discriminating against taxpayers with little investment income, removing investors' incentive to put money into real estate, and causing serious harm to a vital American industry.

"NRC supports the goals of the President in seeking to reform the current tax system," said Williams. "Unfortunately, after careful study and consideration of the President's proposals, we are forced to conclude that at least insofar as real estate investment is concerned, the aggregate effect of the proposals will produce neither fairness, efficiency nor simplicity."

The impacts of the President's tax plan will be felt not only by the real estate industry, but also by the construction and financial industries. Taken together, these industries generate almost 19 percent of the national income and more than 10 percent of its jobs.

"Unless some better sense of balance is maintained between tax laws applicable to real estate investment and other investments competing for taxpayers' dollars," Williams said, "the cumulative adverse effect of the changes made in the 1984 Tax Reform Act and those proposed by the President will drastically depress economic values and employment in the real estate and related industries, while at the same time forcing substantial increases in rents. These results are neither fair nor necessary."

The NRC is a non-profit business league which represents a significant and diverse cross-section of the real estate industry and which is concerned with the overall health and growth of that industry. NRC members include owners, developers and operators of all types of real estate throughout the United States.

# # #

2410B

National Trust for Historic Preservation

1785 MASSACHUSETTS AVENUE, N.W.   WASHINGTON, D.C. 20036   (202) 673-4000

TESTIMONY OF ALAN S. BOYD, CHAIRMAN OF THE BOARD OF TRUSTEES
NATIONAL TRUST FOR HISTORIC PRESERVATION
BEFORE THE SENATE FINANCE COMMITTEE
CONCERNING THE HISTORIC REHABILITATION TAX INCENTIVES

JULY 16, 1985

The 25% investment credit for the rehabilitation of certified historic buildings is a success, working just as Congress intended to stimulate investment in our nation's cities and towns and to preserve the best of our older buildings.

The historic rehabilitation tax credit has:

- generated more than $5 billion in private-sector investment in more than 6,800 historic buildings since January of 1982;
- stimulated the economic revitalization of urban areas and neighborhoods;
- helped restore vitality to small-town main streets;
- created thousands of rental housing opportunities; and
- been responsible for the quality, certified rehabilitation of thousands of historic buildings.

In the absence of preservation tax incentives, market forces will channel investment away from historic buildings. The economic and cultural benefits of historic preservation would be lost.

The National Trust for Historic Preservation, the nation's leading historic preservation organization, urges the Committee to resist tax code amendments that would disadvantage this country's heritage and to retain the historic rehabilitation tax credit in whatever tax legislation the Committee approves.

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JULY 16, 1985

Mr. Chairman and Members of the Committee, I appear before you today to seek your support in retaining one of the most effective urban revitalization incentives ever legislated. The 25% investment credit for the certified rehabilitation of historic buildings is a success, working just as Congress intended to stimulate investment in our nation's cities and towns and to preserve the best of our older buildings. The National Trust urges you to retain this incentive for historic rehabilitation in whatever tax legislation the Committee approves.

When I became a member of the Board of Trustees of the National Trust for Historic Preservation nine years ago, the economic tides were against older cities and their historic buildings. The National Trust, chartered by Congress in 1949 to encourage private-sector efforts to preserve our nation's historic places, had difficulty convincing mayors, community leaders and developers to save fine old buildings instead of tearing them down or building in the suburbs.

160,000 members strong, the National Trust's educational, stewardship, financial assistance and technical assistance programs have made great strides. But we realized early on that, of the approximately 250,000 buildings that are listed on the National Register of Historic Places, only a few can, or should, be museums. The others will survive only if they can be made to serve as someone's home, office, business or factory. Historic neighborhoods will survive only if they retain their economic vitality.

SUCCESSFUL INCENTIVES

The passage of the preservation tax incentives in 1976, and their improvement in 1981 finally made it possible to view historic buildings as a community asset and not a liability. Many who were previously skeptical now are persuaded because of historic preservation's tangible contribution to making our cities and towns more liveable.

The historic rehabilitation tax incentives are a remarkable success. Since the 25% credit took effect in January 1, 1982, the private sector has invested more than $5 billion in more than 6,800 historic buildings throughout the nation. This incentive is stimulating successfully the wholesale renovation and re-use of thousands of the nation's most significant historic buildings and areas.

BENEFITS URBAN AREAS

In large cities, projects aided by the historic rehabilitation tax credit serve as anchors for urban revitalization -- both physically and spiritually. Washington D.C.'s Old Post Office Building and Willard Hotel, St. Louis' soon-to-be-finished Union Station retail, commercial and hotel complex, and the Chicago Theater -- now saved from the wrecking ball -- are all fine examples. Cities successfully capitalize on their historic resources to induce investment, create jobs and stimulate tourism.

The historic rehabilitation tax incentives are also directing investment to older declining neighborhoods in urban areas. They are proving the efficacy of stimulating private investment through targeted tax incentives. Although some projects save landmark structures individually listed in the National Register of Historic Places, the vast majority of investment takes place in historic districts. These neighborhoods contain the vast majority of the nation's historic buildings. Often, these concentrations of historic buildings exist because these areas have been bypassed by economic recovery and its consequent real estate development pressures.

SMALL TOWN RENAISSANCE

The rebirth of many historic small-town main streets demonstrates that concerted action by merchants, landlords and city officials when linked to the historic rehabilitation tax credit can lead to economic renewal. For example, in Athens, Georgia, one of the towns aided by our National Main Street Center, 19 tax credit projects have meant $11.3 million of private investment in their downtown. And, the first new business to open in years in Jim Thorpe, a Pennsylvania town of only 5,000 people, is in an old building alive again because of the historic rehabilitation tax credit.

CREATES HOUSING OPPORTUNITIES

Finally, in cities big and small, the historic rehabilitation tax credit is stimulating the rehabilitation and creation of rental housing opportunities. To date, housing rehabilitation represents more than half of the total number of tax-aided historic rehabilitation projects. According to National Trust estimates, more than 36,000 housing units have been rehabilitated since 1982 using the historic rehabilitation tax credit.

In many areas there are too few housing opportunities, especially for low and moderate income renters. Rent control and declining neighborhood image have led to extensive abandonment. The preservation tax incentives are available for rental housing rehabilitation and have enabled existing owners and residents to create housing opportunities and to enhance neighborhood property values.

Through the National Trust's Inner-City Ventures Fund we have supported housing rehabilitation projects in more than 30 low- and moderate-income neighborhoods. Most of the community-based organizations that received our low-interest loans and grants have used the tax credit to attract private investors to their projects. There are people in the Frog Hollow neighborhood of Hartford, in Atlanta's Cabbagetown and in the Over-The-Rhine section of Cincinnati, the city's largest and poorest neighborhood, whose hope for a decent place to live depends on these incentives.

AIDS STATE AND LOCAL ECONOMIES

As states and localities face across-the board reductions in federal subsidy programs, the historic rehabilitation tax incentives offer a proven tool for stimulating economic development. At the National Trust we have worked to document the impact of these tax incentives. We have developed the only national data base of tax credit projects. From this effort we have learned that, since 1982, certified historic rehabilitation projects have led to more than 180,000 new jobs. Annually, tax-aided projects generate $5.3 billion in increased local retail sales and general business activity.

The treasuries of state and local governments gain from the taxes on worker's earnings, the increased business activity and the increased property tax collections. Assessed values of rehabilitated buildings increase dramatically. A National Trust pilot study in Boston found an average increase in the post-rehabilitation value of historic buildings of 1,000 percent.

ENCOURAGES QUALITY HISTORIC REHABILITATIONS THAT SAVE OUR HERITAGE

The historic rehabilitation tax credit is saving buildings from the wrecking ball and saving historic neighborhoods from destruction. It has generated quality rehabilitation work that furthers the nation's historic preservation policy. The National Historic Preservation Act of 1966 directed that it be "the policy of the Federal Government" to:

> use measures.. to foster conditions under which our modern society and our prehistoric and historic resources can exist in productive harmony and fulfill the social, economic, and other requirements of present and future generations.

The incentive works within the private sector to insure that buildings meet present day community needs. Buildings are selected for rehabilitation by private investors who can find a viable economic use for a property. The operation and maintenance of historic buildings are financed by the ongoing economic activity that takes place within their walls. Thus, historic properties remain as positive contributors to the economic life of our cities and towns.

The process for administering the preservation incentives protects the government's investment and furthers the nation's preservation policy. The plans for proposed tax-assisted historic rehabilitation projects are reviewed by state government historic preservation officials and sent on for final review by the National Park Service of the Department of the Interior.

Thus, state and federal officials review all projects that receive the preservation credit to insure quality rehabilitation work that is consistent with accepted historic preservation practices. Certification for the incentives takes place under published, uniform, objective federal standards that protect the historic integrity of buildings while permitting contemporary economic uses. President Reagan recently presented the National Park Service with one of thirteen Presidential Awards for Design Excellence for its administration of the tax incentive program.

IMPACT OF REPEALING INCENTIVE

The elimination of historic rehabilitation tax incentives would have a devastating effect on revitalization prospects for cities and would doom thousands of historic buildings to demolition. Already, the threat of the legislation has shelved new projects throughout the nation. These projects will not be undertaken if the incentives are lost.

In the absence of tax incentives for historic preservation, market forces generate pressures that lead to the abandonment and destruction of historic buildings. Rising property values, the pressure to maximize development potential under existing zoning and the movement of economic activity away from traditional business areas conspire to drive investment to new construction and away from historic buildings. In addition, old buildings are less adaptable to market change. Consequently, historic preservation takes place in a market environment whose forces always will put historic buildings at a disadvantage.

However, market forces do not take into account the societal benefits of preserving our heritage. These benefits inure to the general public and generations to come. Owners and tenants cannot capture economically the benefits gained by the public-at-large. The sense of community pride and shared history does not pay the mortgage or compensate investors. Without tax assistance, these historic values would go unrealized.

In addition, submitting to the historic preservation project review process, which involves application, negotiation, changes to plans and, sometimes, delay, imposes an economic burden on a project developer. The additional costs created by this process cannot be recouped always in rent payments and, consequently, discourage preservation investment in a tight economic marketplace.

With a historic rehabilitation tax incentive, however, more projects will be undertaken and more areas will realize the benefits of a restored heritage. Only in the past four years have we as a nation invented a successful public policy that persuades developers and the business community to rehabilitate historic buildings. New housing from abandoned buildings. New jobs. New hope for economically depressed areas. This is not the time to change a winning game.

We must not go back to the days when old meant useless and urban renewal all too often meant city wrecking. If this incentive is repealed, we will miss out on thousands of opportunities to make our cities better places to live. We will miss out on thousands of chances to save important historic buildings and neighborhoods for our children and our children's children.

On behalf of those who love our American heritage -- and who among us would deny membership in that group -- I urge you to resist tax code amendments that would disadvantage this country's heritage and to retain the historic rehabilitation tax credit.

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